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# Encumbered Shares


Shaun Martin

*University of San Diego School of Law*, [smartin@sandiego.edu](mailto:smartin@sandiego.edu)

Frank Partnoy

*University of San Diego School of Law*, [fpartnoy@sandiego.edu](mailto:fpartnoy@sandiego.edu)

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## **Law and Economics Research Paper Series**

**October 2004**

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### Abstract

The fundamental assumptions in the law and economics literature about shareholder voting and the one-share/one-vote rule are flawed. The classic view is that share ownership is necessary and sufficient to create voting rights and that such rights should be directly proportional to share ownership. We demonstrate that this assumption is unfounded, both for shares that are “economically encumbered” (held by shareholders who are not pure residual claimants; e.g., a shareholder who owns one share and is also short one or more shares) as well as shares that are “legally encumbered” (held or associated with more than one shareholder; e.g., shares that are loaned to a short, who sells that share to another buyer).

The one-share/one-vote rule is not only economically suboptimal, but results in substantial deleterious consequences. Quorum and regulatory requirements are distorted; mergers and acquisitions are too easily approved; securities class actions are undervalued and simultaneously under- and over-compensate; bankruptcy distributions are over- and under-inclusive; and fixed-ratio stock offers are preferred over economically superior alternatives. These results all derive from an unfounded reliance upon the one-share/one-vote principle and the belief that even economically or legally encumbered shares are entitled to vote.

Encumbered Shares\*  
Shaun Martin and Frank Partnoy

I. INTRODUCTION

Corporate law treats shares equally. For example, in a merger, each share is entitled to one vote. Similarly, in a class action lawsuit or bankruptcy proceeding, each share is entitled to a pro rata recovery. The law and economics literature has uniformly supported these results.

We show that treating shares equally leads to perverse results. Mergers are approved even if they destroy value. Shareholders who should be entitled to recover in class actions or bankruptcy proceedings recover less than their entitlement, whereas shareholders with no entitlement nonetheless recover. Shareholders who should be barred from voting are allowed to vote, while non-shareholders who arguably should be allowed to vote cannot.

We demonstrate that the assumptions about shareholder rights in the law and economics literature are flawed. In the leading article in this field, Frank H. Easterbrook and Daniel R. Fischel maintain that corporate law properly allocates votes to common shareholders as the residual claimants to a corporation's income.<sup>1</sup> This argument contends that common law rules of shareholder voting – specifically, default rules that give one vote to each common share and no (or few) votes to other claimants, broadly known as the rule of “one-share/one-vote” – properly allocate voting rights in ways that minimize agency costs and mimic the rules for which shareholders and other corporate constituents would contract absent transaction costs.<sup>2</sup> Shareholders are granted voting rights, it is contended, and have such rights in direct proportion to the number of shares each holds because they have “similar if not identical” preferences as to their desires for the firm, and are collectively the group with appropriate incentives to make discretionary decisions because they receive most of the marginal gains and incur most of the marginal costs of those decisions.<sup>3</sup>

This agency cost rationale for corporate voting rules was a response to scholarly argument based on the findings of Adolf A. Berle and Gardiner C. Means in the 1930s

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\* The authors are Professors of Law at the University of San Diego School of Law. We have benefited from helpful suggestions by Jill Fisch, Mathew McCubbins, David McGowan, Troy Paredes, Daniel Rodriguez, Steven Schwarcz, Alan Schwartz, and Lynn Stout, and participants at a workshop at the Washington University School of Law.

<sup>1</sup> Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J.L. & Econ. 395, 403-406 (1983); 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.”).

<sup>2</sup> Conversely, the argument goes, federal rules or proposals that would change these minimum-cost default rules are inefficient. Easterbrook & Fischel, Voting in Corporate Law, at 418-27.

<sup>3</sup> Id. at 405; see also Merton Miller & Franco Modigliani, Dividend Policy, Growth, and the Valuation of Shares, 34 J. Bus. 411 (1961) (advancing a similar argument); Myron Scholes, The Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Prices, 45 J. Bus. 179 (1972) (same).

that managers used the voting machinery of public corporations to wrest control from shareholders and expropriate gains for themselves.<sup>4</sup> Since then, hundreds of corporate legal scholars have debated whether competition among states has led to efficient default rules, with many scholars arguing that common law default rules, primarily adopted by competing states (but also by stock exchanges), are efficient,<sup>5</sup> whereas others maintain that Berle and Means were correct and that such competition has generated inefficient and inequitable rules in a race to the bottom.<sup>6</sup>

Specific arguments about corporate voting have surfaced periodically during this broader debate about ownership and control. This occurred most notably in the particular contexts generated by hostile takeovers,<sup>7</sup> shareholder activism,<sup>8</sup> and corporate scandals.<sup>9</sup> Notwithstanding these limited forays into the arena of shareholder voting, scholars have not seriously challenged the theoretical underpinnings of the dominant view of corporate voting. Instead, Easterbrook and Fischel's work on corporate voting (and its progeny) have become largely canonical, and its assumptions not subject to vigorous inspection.<sup>10</sup>

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<sup>4</sup> See Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (1932).

<sup>5</sup> See, e.g., Roberta Romano, *The Genius of American Corporate Law* (1993); Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 73 (1991); Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. Legal Stud.* 251 (1977).

<sup>6</sup> See, e.g., Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 *Harv. L. Rev.* 1435 (1992); William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 *Yale L.J.* 663 (1974).

<sup>7</sup> See, e.g., Sanford J. Grossman & Oliver D. Hart, *One Share-One Vote and the Market for Corporate Control*, 20 *J. Fin. Econ.* 175 (1988) (analyzing the optimality of the one-share/one-vote rule for allocating control); Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 *Colum. L. Rev.* 979 (1988); Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 *Va. L. Rev.* 807 (1987).

<sup>8</sup> See, e.g., Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 *Yale J. Reg.* 174 (2001); Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 *Calif. L. Rev.* 1 (1997); Lynne L. Dallas, *The Control and Conflict of Interest Voting Systems*, 71 *N.C. L. Rev.* 1 (1992); John C. Coffee, Jr., *Liquidity vs. Control: The Institutional Investor as Corporate Monitor*, 91 *Colum. L. Rev.* 1277 (1991).

<sup>9</sup> See, e.g., William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 *Tul. L. Rev.* 1275 (2002); Jeffrey N. Gordon, *What Enron Means for Management and Control of the Modern Business Corporation: Some Initial Responses*, 69 *U. Chi. L. Rev.* 1233 (2002).

<sup>10</sup> See, e.g., Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 *U. Chi. L. Rev.* 1103, 1121 (2002) (“As Frank Easterbrook and Daniel Fischel have shown, in a system with voting rights that are not proportional to the voter’s stake in the enterprise, there will be a reduced incentive for voters to make optimal decisions, because the gains or losses stemming from these decisions will not be internalized at a level corresponding to the influence of one’s vote. Therefore any rule other than one-share/one-vote wastefully increases the agency costs associated with the corporate form.”); cf. Dale A. Oesterle & Alan R. Palmiter, *Judicial Schizophrenia in Shareholder Voting*, 79 *Iowa L. Rev.* 485 (1994) (questioning the development of the law and economics theory of corporate voting, but noting that the “theory holds together as far as it goes”).

Recent analyses of corporate voting have similarly focused on the voting mechanism but have ignored the normative basis for the underlying investiture of voting rights.<sup>11</sup>

Meanwhile, changes in the markets and in finance theory make it plain that the assumptions central to the paradigmatic position on corporate voting no longer hold, if they ever did. It simply is not true that the “preferences of shareholders are likely to be similar if not identical”<sup>12</sup> Shareholders are not necessarily, or even commonly, in the residual claimant position that the literature has heretofore assumed. Parties instead routinely utilize financial derivatives and structured finance techniques to reallocate various interests in the firm, including both residual claims and voting rights.

For example, Easterbrook and Fischel assume that “[i]t is not possible to separate the voting right from the equity interest.”<sup>13</sup> But equity derivatives make it a straightforward exercise to do precisely that, and to separate a vote from the economic returns of stock.<sup>14</sup> Moreover, financial contracting increasingly results in shareholders holding not “pure” residual claims, but portfolio positions that include options, forward contracts, and other financial derivatives. These differing positions of such shareholders pose a serious challenge to the conclusions of the dominant literature.<sup>15</sup>

Consider the simplest case: a shareholder who owns one share and also holds a one-share short position.<sup>16</sup> That shareholder has a residual claim to the corporation’s income through the share, but the incentives associated with that claim are directly offset

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<sup>11</sup> See, e.g., Paul H. Edelman & Randall S. Thomas, Voting Models, Corporate Elections and Takeover Bids, July 30, 2003 (working paper, available at SSRN); Ronald J. Gilson & Alan Schwartz, Sales and Elections as Methods of Transferring Corporate Control, 2 *Theoretical Inq. L.* 783 (2001); Lucian Bebchuk & Oliver Hart, Takeover Bids vs. Proxy Fights in Contests for Corporate Control, Harvard John M. Olin Discussion Paper Series, Paper No. 336 (October 2001) (Nat’l Bureau of Econ. Res., Working Paper No. 8633 (2001)).

<sup>12</sup> Easterbrook & Fischel, Voting in Corporate Law, at 405.

<sup>13</sup> *Id.* at 410

<sup>14</sup> For example, parties can purchase stock and simultaneously sell equity derivatives representing a short position in that stock. See Frank Partnoy, Some Policy Implications of Single-Stock Futures, *Futures & Derivatives Law Report*, Mar. 2001, at 8; see also infra (discussing additional encumbrances that can effectively separate the vote from the underlying equity interest).

<sup>15</sup> When shareholders’ interests are not homogenous, it is not possible to aggregate shareholder preferences into a consistent system of choices. See Matthew D. Adler & Eric A. Posner, Implementing Cost-Benefit Analysis When Preferences Are Distorted, 29 *J. Legal Stud.* 1105 (2000); Kenneth J. Arrow, Social Choice and Collective Values (2d ed. 1963). Scholars have challenged the homogeneity assumptions of law and economics scholarship in other areas of corporate law. See, e.g., Lynn A. Stout, Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation, 81 *Va. L. Rev.* 611 (1995); Andrei Shleifer, Inefficient Markets: An Introduction to Behavioral Finance (2000). Notwithstanding the heterogeneity of portfolio positions, however, no one has applied these same finance principles and practices to corporate voting; instead, the optimality of the dominant Easterbrook and Fischel principle of one-share/one-vote has been assumed.

<sup>16</sup> To establish a short position, a person typically borrows a share and sells it. See Short Sales, SEC Concept Release No. 34-42037, File No. S7-24-99, n.1 (1999). Synthetic short positions also can be established by selling single-stock futures or by selling an at-the-money call option (with an exercise price equal to the price of the stock), buying an at-the-money put option, and borrowing the present value of the exercise price.

by those of the short position. Whatever benefit results from an increase (or decrease) in the value of the stock results in an equivalent decrease (or increase) in the value of the short position. Such a short-holding shareholder retains a residual claim to the corporation's income, but does not have the same economic incentives as a "pure" shareholder; nonetheless, she remains entitled to a vote. Even a shareholder who owns a single share and simultaneously holds a ten-share short position retains a vote, even though her net economic interest is directly counter to that of other shareholders.

We discuss more complex cases of such differential incentives in Part III.A., including shareholders with put and/or call positions or other derivative claims. Such examples are the norm in modern financial markets, as shareholders – particularly large institutions and hedge funds – typically hold portfolios that can include both short and derivative positions.

Conversely, non-shareholders frequently acquire through financial engineering synthetic residual positions with incentives equivalent to a "pure" residual claim.<sup>17</sup> Such non-shareholders face the exact same incentives as shareholders in the world imagined by Easterbrook and Fischel; however, notwithstanding those homogeneous incentives, such non-shareholders do not have a vote. Non-shareholders who replicate share positions using financial derivatives acquire portfolio positions that mimic those of pure residual shareholders. Yet neither market pressures nor regulatory initiatives have led to the shifting of voting rights from shareholders who do not have the proper incentives to non-shareholders who do.

Modern practices of borrowing shares and voting in "street name"<sup>18</sup> further complicate the analysis of voting. Consider the typical owner of a share eligible to be loaned, often because she holds these shares in a margin account. She typically does not know whether her shares actually have been loaned out (e.g., to a client of the broker who wishes to sell the shares short). Moreover, she assumes that because she owns a share – and hence will incur gains or losses from movement in the share price – she is entitled to vote that share. If, however, one of her shares has in fact been loaned, she technically should not be entitled to vote it, because only one vote is allowed per share, and her share has been loaned to a short seller, who has sold that loaned share (alongside the right to vote it) to someone else. A single share should result in a single vote, not two; as a result, by loaning the share to the short, the original shareholder should have divested herself of the vote, which would then belong to the person who bought the share from the short.

However, if shareholders believed that they lost voting rights when their shares were loaned, they might be reluctant to lend shares, to the detriment of both brokers, who receive (sometimes substantial) compensation from share lending, as well as to market liquidity. The bizarre solution to this problem is that brokers allow *both* shareholders to vote, and simply reallocate the votes from shareholders who have not submitted proxies

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<sup>17</sup> A non-shareholder could replicate a share position by purchasing a single-stock future; by purchasing an at-the-money call option, selling an at-the-money put option, and lending the present value of the exercise price of the options; or by entering into other similar equity derivatives. See *infra* (Part III.B). Such positions might be called "synthetic" shares.

<sup>18</sup> Shares held in "street name" are held in the name of a broker or other nominee instead of the customer, primarily to facilitate share transfer.



to shareholders who have voted but whose shares have been loaned out.<sup>19</sup> As a result, both the original owner and the shareholder who purchased this same loaned share are each allowed to vote; in essence, a single share can generate multiple votes.<sup>20</sup>

Shareholders are unaware of this vote switching, which works only if few shareholders actually vote. Only voter apathy and manipulation of the voting process prevent pervasive overvoting. This is not merely a theoretical problem: in some cases, the total number of votes cast may exceed the actual number of shares.<sup>21</sup>

We characterize as “economically encumbered” those shares that are held by stockholders who may lack the otherwise homogeneous incentives generated by “pure” share ownership (e.g., who hold both a share and a short or other derivative position). We characterize as “legally encumbered” those shares that are held by stockholders who may have a legal impediment to voting such shares (e.g., who have loaned out such shares to a broker or short-seller, or who maintain a synthetic position that mimics a share but does not create the right to vote).

We discuss herein whether the dominant one-share/one-vote principle is in fact the optimal default value in existing financial markets. First, we examine the rationale for one-share/one-vote in a more complex and realistic institutional environment than other scholars have assumed. Second, we consider whether current policy of corporate voting could be improved given contemporary financial structures; specifically, we propose and assess a rule that certain types of encumbered shares should not be entitled to a vote.<sup>22</sup> Finally, we evaluate the potentially deleterious effects of the existing one-share/one-vote regime on quorum and regulatory requirements, approval of corporate mergers and acquisitions, resolution of securities class actions, bankruptcy distributions, and selection of fixed-ratio stock offers as opposed to alternatives.

We address these issues in four additional parts. Part II assesses the development of corporate voting practices and regulation. Our account of this practice differs from that described in the law and economics literature: the evolution of the one-share/one-vote rule is not as straightforward as has been assumed, and practices and regulation

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<sup>19</sup> In other words, the initial long position technically loses its vote when the share is loaned out in a short sale, but the broker nevertheless permits that long position to vote, so long as there are other long positions not voting. The broker simply allows one long position to vote another’s unvoted shares. Share lending thereby effectively creates new votes, as each share is passed around to numerous investors, each of whom assumes that she is entitled to vote the shares.

<sup>20</sup> Indeed, a single share could generate more than two votes if that share is loaned more than once – a not uncommon event (e.g., a share is loaned by the original stockholder to a short, who then sells the share to a new buyer, who may in turn loan the share to another short, and so on).

<sup>21</sup> See, e.g., Ganesh, LLC v. Computer Learning Centers, Inc., 183 F.R.D. 487, 491 (E.D. Va. 1998) (noting that the six million shares of CLC sold short exceeded the company’s actual float).

<sup>22</sup> We propose, for example, that certain types of economically encumbered shares should retain a vote only to the extent their holder retains a “pure” residual interest. For linear (i.e., long and short) positions, the calculation of such a *net* residual interest would be simple (e.g., one share plus one short would receive zero votes, two shares plus one short would receive one vote, and so on). For non-linear (i.e., options) positions, the effect on voting would more complex, and we consider the merits of a voting regime based on the modern theory of options pricing.

continue to evolve, particularly in response to differential shareholder preferences and financial innovation. Part III then analyzes the various manners in which shares can be encumbered, and sets forth the initial argument that encumbered shares should not be entitled to vote. Part IV further considers whether non-shareholders with synthetic residual claims should be entitled to vote. Part V finally analyzes the policy effects of the proposed encumbered share rule in several areas, and identifies the deficiencies of the existing regime.

## II. THE EVOLUTION OF CORPORATE VOTING PRACTICES AND REGULATION

The practice of corporate voting has evolved in fits and starts, beginning with voting practices that treated shareholders as individual voters, then moving toward one-share/one-vote, and in recent decades moving to a rich mix of practices, including multiple-class common and preferred shares, as well as shares with multiple *de facto* votes as a result of share lending. The changes have been driven both by market forces and regulatory initiatives. This is not (or at least not entirely) a story about the efficient evolution of common law rules.

Corporate voting practices initially arose from analogous rules applicable to governmental decision making.<sup>23</sup> Corporations or similar legal entities were initially formed to undertake governmental functions, and accordingly carried the same voting practices as those familiar from the political process. Larger shareholdings typically were entitled to a greater share of control, just as the wealthy members of society had a greater governance role. For example, the Roman government created *publicani*, legal bodies resembling the modern corporation, with ownership divided into *partes*, or shares, of two types: large shares (*socii*) held by the wealthiest members of society, and small shares (*particulae*), held more widely by the public.<sup>24</sup> One-share/one-vote was not the dominant rule.

The middle ages were not conducive to share ownership, but the early joint-stock companies of the fourteenth century were similar to the Roman *publicani*.<sup>25</sup> At common law, each shareholder had one vote regardless of the number of shares she owned.<sup>26</sup> In Europe, one-shareholder/one-vote became a common practice, and was widely perceived to be fairer and more democratic than one-share/one-vote.<sup>27</sup> The general conception of a

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<sup>23</sup> See David L. Ratner, The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote", 56 Cornell L. Rev. 1, 44-53 (1970); cf. Zohar Goshen, Controlling Strategic Voting: Property Rule or Liability Rule, 70 S. Cal. L. Rev. 741, 789-93 (1997) (concluding that more recent judicial treatment of corporate voting favors dictatorship, not democracy).

<sup>24</sup> See Edward Chancellor, *Devil Take the Hindmost* 4-5 (1999).

<sup>25</sup> See Fernand Braudel, *The Wheels of Commerce* 101 (1982); see generally Meir Cohn, *The Origins of Western Economic Success: Commerce, Finance, and Government in Pre-Industrial Europe* (draft 2003), available at <http://www.dartmouth.edu/~mkohn/>.

<sup>26</sup> See David Ratner, The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote", 56 Cornell L. Rev. 1 (1970).

<sup>27</sup> See Colleen A. Dunlavy, *Corporate Governance in the Late 19th Century Europe and USA - The Case of Shareholder Voting Rights*, in *Comparative Corporate Governance* 5 (Klaus J. Hopt et al. eds., 1998).

shareholder meeting was of a meeting among citizens of a small village, who would vote on the group's business by show of hands.<sup>28</sup>

During the sixteenth century, joint-stock companies were formed in England with divided shares, with ownership concentrated among a few wealthy individuals. Members of the public bought various securities, but a series of speculative bubbles and crashes through the nineteenth century (e.g., East India Company, South Sea Bubble, Latin American mining) discouraged broad participation in corporations and corporate governance.

By the nineteenth century, companies in Europe had moved some distance from one-shareholder/one-vote toward one-share/one-vote.<sup>29</sup> Various non-linear voting schemes developed during this period, with, for example, small shareholdings receiving one vote per share, and votes per share declining above some specified level.<sup>30</sup> The concept of one-share/one-vote nonetheless remained controversial, and even during the nineteenth century, default rules of one-share/one-vote nevertheless capped voting per shareholder (e.g., at ten shares per person).

Consider the following two examples from this period:<sup>31</sup>

<u>England</u>	
<u>Shareholdings</u>	<u>Votes</u>
First 10 shares	1 vote per share
Every add'l 5 shares to 100	1 vote per 5 shares
Every add'l 10 shares	1 vote per 10 shares

<u>France</u>	
<u>Shareholdings</u>	<u>Votes</u>
0-4 shares	None
5-10 shares	1 vote
11-20 shares	2 votes
21-40 shares	3 votes
40 shares or more	5 votes

In the English example, voting is limited as shareholdings increase. In the French example, small shareholdings receive no vote at all, but large shareholdings are limited as well. In neither case is one share generally entitled to one vote. Germany imposed similar voting ceilings for companies listed on the stock exchange,<sup>32</sup> and German corporate law prohibited shareholders with more than five or ten percent of a company's

<sup>28</sup> See Katharina Pistor, Yoram Keinan, Jan Kleinheisterkamp & Mark D. West, The Evolution of Corporate Law: A Cross-Country Comparison, 23 U. Pa. J. Int'l Econ. L. 791, 819 (2002) (citing a finding that "unless the company's regulations otherwise provide, voting is in the first instance by show of hands, i.e., those present indicate their views by raising their hands.").

<sup>29</sup> See generally Stuart Banner, The Pernicious Art of Securities Regulation: Cultural and Political Roots, 1690-1860 (1998).

<sup>30</sup> See David Ratner, The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote", 56 Cornell L. Rev. 1 (1970).

<sup>31</sup> See Pistor et al., at 819.

<sup>32</sup> See Pistor et al., at 820 n.126.

equity from voting any additional votes over that percentage.<sup>33</sup> These hybrid approaches were a compromise between the politically democratic principle of one-shareholder/one-vote and the economically democratic principle of one-share/one-vote.

One-share/one-vote did not become the predominant legal rule in Europe until it had already become firmly established in the United States. Consistent with historical practice in Europe, the early U.S. approach was to limit by statute the voting power of any single stockholder.<sup>34</sup> The first Delaware Corporate Law, for example, permitted corporations to determine in their by-laws “what number of shares shall entitle the stockholders to one or more votes.”<sup>35</sup> In 1897, the Delaware Constitution was amended to impose the requirement of one-share/one-vote in “all elections where directors are managers of stock corporations.”<sup>36</sup> But the Delaware legislature quickly removed this mandatory rule, replacing it with what has become Section 212(a) of the General Corporation Law, which provides for a one-share/one-vote default rule “unless otherwise provided in the certificate of incorporation.”<sup>37</sup>

Delaware law accordingly presently establishes a default rule of one-share/one-vote, but continues to allow voting schemes similar to the English and French examples above.<sup>38</sup> Other American jurisdictions have taken similar approaches, although some formally require one-share/one-vote regardless of contrary corporate preference.<sup>39</sup>

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<sup>33</sup> See William W. Bratton & Joseph A. McCahery, Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference, 38 Colum. J. Transnat'l L. 213, 237 n. 71 (1999).

<sup>34</sup> See Providence & Worcester Co. v. Baker, 378 A.2d 121, 125 (Del. 1977) (describing early practice).

<sup>35</sup> 17 Del. L. Ch. 147, § 18 (1883).

<sup>36</sup> Delaware Constitution, Article 9, § 6 (1897).

<sup>37</sup> Del. Code § 212(a).

<sup>38</sup> See Providence & Worcester, 378 A.2d at 121 n.2 (upholding an 1844 voting provision providing that “each shareholder shall be entitled to one vote for every share of the common stock of said company owned by him no exceeding fifty shares, and one vote for every twenty shares more than fifty, owned by him; provided, that no stockholder shall be entitled to vote upon more than one fourth part of the whole number of shares issued and outstanding of the common stock of said company, unless as proxy for other members.”). Early bank charters had similar capped provisions. See Oesterle & Palmiter, Judicial Schizophrenia in Shareholder Voting, 79 Iowa L. Rev. 485, 511 n.52 (1994).

<sup>39</sup> These states would require that even encumbered shares be entitled to vote, even if corporations wanted to divest such shares of this right. For example, New York provides that “every stockholder of record must be entitled at every stockholders’ meeting to one vote for every share standing in his name on the record of stockholders.” 9 N.Y. Jur. 2d Banks and Financial Institutions § 83; see also 8 Fletcher Cyclopedia of Private Corp. § 4209 (noting that corporate bylaws are ineffective to deprive a shareholder “of either the right to vote given by charter or statute, or the number of votes to which the shareholder is entitled, or impose new qualifications on the shareholder as a voter or unreasonable restrictions on the exercise of the shareholder’s rights”). Some states have enshrined this principle in their Constitution, unalterable by even deliberate and unanimous corporate election. See, e.g., State ex rel. Dewey Portland Cement Co. v. O’Brien, 142 W.Va. 451, 463-64 (1956) (holding that corporation’s issuance of non-voting stock was barred by Article XI, Section 4, of the Constitution of West Virginia, which requires “that in all elections for directors or managers of incorporated companies, every stockholder shall have the right to vote, in person or by proxy, for the number of shares of stock owned by him, for

The impetus for a one-share/one-vote requirement in U.S. markets was not competition for state corporate charters; most states permitted, and still permit, the creation of classes of shares with limited voting rights. Nor did the pressure come initially from market participants; during the early twentieth century, companies had little difficulty selling shares with no voting rights at all. Shareholders apparently understood that their power came from the threat to exit by selling shares, not from the (rarely exercised) right to vote.<sup>40</sup>

Instead, the requirement of one-share/one-vote stemmed from a populist uprising and the New York Stock Exchange's worries about possible federal regulation (and related damage to its reputation). During the 1920s, corporations increasingly restricted the voting rights of certain classes of shareholders, moving away from one-share/one-vote. In 1925, when a few leading corporations, including Dodge Brothers, Inc., and Industrial Rayon Corporation, sold major issues of nonvoting common stock, there was widespread public criticism.<sup>41</sup> In response, the NYSE began disapproving of the listing of nonvoting common stock issues. As Joel Seligman has concluded, "[i]n retrospect, the primary motivation for the NYSE's initial decision on nonvoting common stock was concern about public opinion."<sup>42</sup>

During the next several decades, the NYSE generally continued its practice of refusing to list companies with nonvoting shares, with a few prominent exceptions when it was politically or economically inconvenient.<sup>43</sup> This relatively stable period apparently is the one from which Easterbrook and Fischel derive their conclusion that one-share/one-vote has been the dominant rule and practice.

In the 1980s, competition in the market for corporate control increased markedly, and voting practices became more important.<sup>44</sup> The threat of hostile takeovers led

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as many persons as there are directors or managers to be elected"); see also 7 Ill. Prac., Business Organizations § 9.15 (noting that the 1870 Constitution of Illinois provided that "[t]he General Assembly shall provide, by law, that in all elections for directors or managers of incorporated companies, every stockholder shall have the right to vote, in person or by proxy, for the number of shares of stock owned by him, for as many persons as there are directors or managers to be elected, or to cumulate said shares, and give one candidate as many votes as the number of directors multiplied by the number of his shares of stock shall equal, or to distribute them on the same principle among as many candidates as he shall think fit; and such directors or managers shall not be elected in any other manner").

<sup>40</sup> See Henry G. Manne, Some Theoretical Aspects of Share Voting, 64 Colum. L. Rev. 1427 (1964).

<sup>41</sup> See Joel Seligman, Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy, 54 Geo. W. L. Rev. 687, 695 (1986).

<sup>42</sup> Id.

<sup>43</sup> For example, in 1956, the NYSE agreed to list a class of shares of Ford Motor Company, even though the Ford family controlled 40 percent of the company's voting power. See Robert B. Thompson, Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation, 38 Wake Forest L. Rev. 961, 977 (2003). The NYSE also has listed shares of The New York Times, even though public shares had only one vote, while the insider (family) stock had ten.

<sup>44</sup> Easterbrook and Fischel argue that the private value of control was limited by the fact that all shareholders held a claim to any upside generated by a control change; finance scholars modeled the incentive function of the capital structure by assuming control has a private value.

managers to favor moving away from the principle of one-share/one-vote to other voting regimes, most notably dual-class recapitalizations.<sup>45</sup> Managers perceived that one-share/one-vote was costly to them, and began to lobby for changes to NYSE practice. At the same time, the NYSE, having enjoyed a dominant market position for decades, found its listings challenged by the NASDAQ and AMEX, neither of which required one-share/one-vote. In response to these political and economic pressures, the NYSE abandoned its early policy, and began permitting voting regimes other than one-share/one-vote, formally liberalizing its approach in 1986 (three years after Easterbrook and Fischel's article on corporate voting was published).<sup>46</sup>

Scholars generally were critical of the NYSE's policy shift.<sup>47</sup> In response, and with the support of several legal academics,<sup>48</sup> in 1988 the SEC promulgated Rule 19c-4, which required the exchanges to bar the listing of a corporation that acted to reduce the voting rights of any class of shareholders. However, two years later, the Court of Appeals for the D.C. Circuit held that this rule was beyond the SEC's authority.<sup>49</sup> Ultimately, the SEC pressured the exchanges to adopt some limitations on the issuance of nonvoting shares or multiple-class shares with different voting rights. Exchange rules

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See, e.g., Sanford J. Grossman & Oliver D. Hart, One Share-One Vote and the Market for Corporate Control, 20 J. Fin. Econ. 175 (1988); Milton Harris & Artur Raviv, Corporate Governance: Voting Rights and Majority Rules, 20 J. Fin. Econ. 203 (1988).

<sup>45</sup> In a dual-class recapitalization, a corporation issues a new class of common shares with voting rights superior to those of the original shares. The original shares typically receive compensation in the form of a higher dividend. One theory supporting management's decision to issue a new class of shares with superior voting rights is that if the new shares are friendly to management, they will vote to oppose a hostile takeover.

<sup>46</sup> The impact of competition from NASDAQ and AMEX upon the NYSE was evident even before Easterbrook and Fischel published their seminal piece. For example, in 1982, General Motors acquired EDS and issued restricted voting shares, daring the NYSE to delist its shares. In response, the NYSE diluted its rule, encouraging other companies to establish dual-class share structures.

<sup>47</sup> See, e.g., Sanford J. Grossman & Oliver D. Hart, One Share-One Vote and the Market for Corporate Control, 20 J. Fin. Econ. 175 (1988) (one-share/one-vote is the optimal rule for allocating control); Milton Harris & Artur Raviv, Corporate Governance: Voting Rights and Majority Rules, 20 J. Fin. Econ. 203 (1988) (same conclusion for both simple majority voting rules and one-share/one-vote). Scholars also noted the irony of managers' virulent opposition to weighted voting schemes while simultaneously embracing "super voting" stock – which they awarded to friendly interests – to fend off hostile takeovers. See Douglas M. Branson, Corporate Governance "Reform" and the New Corporate Social Responsibility, 62 U. Pitt. L. Rev. 205, 209 n.19 (2001).

<sup>48</sup> Ronald Gilson, Jeffrey Gordon, Roberta Karmel, Manning Warren, and Elliott Weiss submitted comments in support of the rule. See Voting Rights Listing Standards - Disenfranchisement Rule, Exchange Act Release No. 25891 (July 7, 1988); see also Stephen M. Bainbridge, The Short Life and Resurrection of Rule 19c-4, 69 Wash. U. L. Q. 565 (1991); John C. Coffee, Jr., Racing Toward the Top?: The Impact of Cross-Listings and Stock Market Competition on Corporate Governance, 102 Colum. L. Rev. 1757 (2002); Manning Gilbert Warren III, One Share, One Vote: A Perception of Legitimacy, 14 J. Corp. L. 89, 93 n.36 (1988).

<sup>49</sup> See Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (invalidating one-share/one-vote rule as exceeding SEC authority and improperly intruding on state corporate law).

presently allow listed companies to issue nonvoting or limited-voting classes of shares, but with certain safeguards and restrictions.<sup>50</sup>

During the most recent decade, market practices have continued to evolve, and the recent wave of financial innovation has once again transformed corporate voting practices. Corporations have added new financial instruments – most without voting rights – to their capital structures, including various hybrid securities, tracking stocks, and securities whose voting rights depend on the length of a shareholder’s holding period.<sup>51</sup> Meanwhile, market participants and regulators have become much more concerned with how corporate voting is affected by takeover defenses and proxy disclosure rules than with the rules allocating votes among shareholders.

In general, one-share/one-vote remains the dominant practice and rule, with prominent exceptions. However, the development of one-share/one-vote has not followed a simple evolutionary path. The various rules and practices have instead evolved primarily in response to either a fear of regulation or direct regulatory initiative, as regulators (and scholars) argued that one-share/one-vote would properly align control and ownership. In contrast, market pressures and regulatory competition among states and exchanges have pushed in the opposite direction, away from one-share/one-vote, as private parties have attempted to reallocate control away from ownership and states and exchanges have permitted corporations to reallocate voting control. In other words, one-share/one-vote is the majority rule notwithstanding market pressure and competition to the contrary. One-share/one-vote remains a valuable default rule in many instances,<sup>52</sup> but the characterization of the development of the rule as efficient historical practice is incomplete.

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<sup>50</sup> See, e.g., NYSE Listed Company Manual, 313.00(B)(1)-(3) Voting Rights (2004).

<sup>51</sup> Such arrangements have included, for example, allocating more votes to long-term shareholders than to short-term shareholders, presumably to discourage arbitrageurs from taking short-term speculative positions. See, e.g., Potlatch Corporation, Restated Certificate of Incorporation (Form 10-K) (available at <http://www.sec.gov/Archives/edgar/data/79716/000103221003000293/dex3a.htm>) § V (Sept. 27, 2002) (granting one vote per share held for less than 48 months and four votes per share for shares held 48 months or longer).

<sup>52</sup> Several studies have found that the one-share/one-vote regime has value. See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, Legal Determinants of External Finance, 52 J. Fin. 1131, 1142 (1997); Stijn Claessens, Simeon D. Djankov, Joseph P.H. Fan & Larry H.P. Lang, On Expropriation of Minority Shareholders: Evidence from East Asia (World Bank, Working Paper No. 2088, 1999) ([http://papers.ssrn.com/paper.taf?abstract\\_id=202390](http://papers.ssrn.com/paper.taf?abstract_id=202390)); Bernard Black & Reinier Kraakman, A Self-Enforcing Model of Corporate Law, 109 Harv. L. Rev. 1911, 1945 (1996); see also Bernard S. Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 UCLA L. Rev. 781 (2000) (one-share/one-vote is among the rules important for controlling managerial self-dealing, because it limits the disparity between voting control and economic rights and will reduce insiders’ incentives to self-deal). Conversely, the absence of a one-share/one-vote rule has costs. See Jeffrey N. Gordon, Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 76 Cal L Rev 3, 60 (1988) (“Given the flaws of shareholder voting, how can the firm provide convincing assurances that specific constraints, such as single class common, will have continuing effect? In this context, the NYSE one share, one vote rule may be understood as a way of bonding the firm’s promise to maintain the single class capital structure without renegotiation.”); see also *id.* at 33-36 (dual class recapitalizations generate significant negative returns upon announcement).

### III. THE PROBLEM OF ENCUMBERED SHARES

The history of corporate voting raises several unanswered questions about current (and future) practices and rules. The prevailing public corporation approach to voting rights is in stark contrast to the innovative structures used by private corporations<sup>53</sup> and in the financial markets generally. Moreover, the widespread use of equity derivatives, as well as a marked increase in share lending and shorting, have changed the economic profile of share-based portfolios. In this Part, we address how such innovations have changed the analysis of voting of shares held by participants engaged in or affected by these new activities. Specifically, we consider whether these activities “encumber” shares in ways that would justify moving further away from one-share/one-vote.

Shares can be encumbered in two ways. First, shares can be paired with other portfolio positions such that the shareholder faces incentives different from those of a “pure” residual claimant. We call such shares “economically encumbered.” Second, shares can be associated with share lending transactions that distort the mechanics of shareholder voting. We call such shares “legally encumbered.” In either case, there are strong arguments that at least certain encumbered shares should not carry voting rights. Put another way, one-share/one-vote is arguably an inefficient rule when applied to such shareholdings.

#### A. *Economic Encumbrances*

Homogeneity of preferences is a key assumption in the law and economics model of corporate voting. For example, Easterbrook and Fischel assume that each shareholder has equal incentive – proportional to share ownership – to maximize firm value.<sup>54</sup> They conclude that the widespread practice of one-share/one-vote, as well as the prohibition on selling votes, follows from these assumptions.<sup>55</sup> Conversely, Easterbrook and Fischel admit that if shareholders are not homogeneous in their preferences, then the efficiency justification of a one-share/one-vote rule does not hold.<sup>56</sup>

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<sup>53</sup> In contrast to public corporations, privately-held corporations – particularly those that seek venture capital – generally do not follow the practice or rule of one-share/one-vote. Instead, privately-held corporations allocate voting rights in a custom tailored fashion, typically to various classes of preferred shareholders, depending on the amount and timing of their investment.

<sup>54</sup> Easterbrook & Fischel, *The Economic Structure of Corporate Law*, at 69-71; Easterbrook & Fischel, *Voting in Corporate Law*, at 405 (“The preferences of one class of participants are likely to be similar if not identical.”).

<sup>55</sup> Easterbrook & Fischel, *The Economic Structure of Corporate Law*, at 64-68 & 72-75; see also Easterbrook & Fischel, *Voting in Corporate Law*, at 409 (“Those 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.”).

<sup>56</sup> See Easterbrook & Fischel, *Voting in Corporate Law*, at 405 (“It is well known, however, that when voters hold dissimilar preferences it is not possible to aggregate their preferences into a consistent system of choices.”).



1. *A Taxonomy.*

The homogeneity assumption that underlies the one-share/one-vote rule, however, is untenable for several different reasons. First, as abundant evidence demonstrates, shareholders as individuals are not homogeneous. The behavioral finance literature has demonstrated that demand curves for financial assets often are downward sloping, and that shareholders accordingly have dramatically different preferences.<sup>57</sup> Moreover, the empirical fact that shares with stronger voting rights are more valuable is inconsistent with assumed homogeneity.<sup>58</sup> If shareholders had uniform expectations, they would (correctly) assume that their colleagues would vote the same way they would, and hence votes would have little or no value. Conversely, shareholders with heterogeneous expectations would expect that their colleagues, if they controlled the firm, might act in ways contrary to their own interests, and therefore would believe preserving their vote is important (and valuable).<sup>59</sup> The available evidence is thus inconsistent with alleged homogeneity.

But one need not accept the behavioral finance arguments to conclude that certain shareholders do not face the same incentives as a pure residual shareholder. With respect to economically encumbered shareholders, it is simply a matter of logic that these holders do not share preferences identical to those of non-encumbered shareholders; further, the traditional arguments in favor of granting voting rights to such shares do not apply. The economic encumbrance argument is accordingly supported by – but does not depend on – the findings of behavioral finance.

The first, and simplest, example is of a shareholder with a short position that directly offsets her long position. Suppose A and B each own ten shares, and C owns zero shares. Then A and B have voting rights, but C does not. Now suppose B decides she does not want to be exposed to the risks associated with these shares, but also does not want to or cannot sell her shares (perhaps because her shares were awarded as compensation but have not yet vested), so instead she sells short ten shares, borrowing them from her broker (who obtains them from the account of some other shareholder). The allocation of voting rights has not changed; A and B still vote, and C does not. B retains a vote even though she now would be indifferent to a proposal that would increase the value of the corporation's shares. Put another way, B and C share the same economic incentives, but B has a vote while C does not.

Moreover, B retains a vote even if her short position is for more shares than the number of shares she owns. For example, even if B sold short twenty (or twenty thousand) shares, so that she would oppose a proposal that would increase the value of

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<sup>57</sup> See Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* 16-22 (2000).

<sup>58</sup> Easterbrook & Fischel, *The Economic Structure of Corporate Law*, at 71 (noting difference of two to four percent in value).

<sup>59</sup> Indeed, the fact that the price of stock falls on the record date relevant to a tender offer suggests that some shareholders (such as arbitrageurs or option holders) have starkly divergent interests in the vote, so that stock sold without the ability to counteract these competing interests through voting (i.e., stock sold after the record date) is worth less than stock with a vote.

the corporation's shares – and would favor a proposal that would reduce the shares' value – she nevertheless would retain the votes associated with the ten shares she owns.<sup>60</sup>

Second, suppose B owns ten shares and purchases an at-the-money<sup>61</sup> put option on ten shares. Now, B's incentives differ from A's in two respects: (1) B has a limited downside – because of the insurance from the put option, she is indifferent as to decisions that would reduce the value of shares; and (2) B has different short- and long-run incentives. Finance scholars have argued that maximizing short-term share value is not a problematic corporate objective, because the short-term share price should reflect the net present value of longer-term future opportunities. However, if shareholders differ as to how and when they would benefit from future events, they will follow different decision rules. In this case, B would prefer to vote against a value increasing proposal now, even though she later would favor such a proposal after her put option had expired. B similarly might vote against a value-enhancing opportunity now in order to preserve an alternative (competing) opportunity that would be less valuable to the firm but – because it might only appear only in the future – would result in an increase in stock value only after her put option had expired, thereby maximizing B's (but not the corporation's) expected return.

Yet, in all of these examples, B retains the right to vote her ten shares, regardless of the size of her put position. Even if she has a very substantial put position, so that she would benefit in the short run (i.e., before the exercise date) from a decline in the value of the shares, legal rules and prevailing corporate voting practices nevertheless permit her to vote. Moreover, unlike in the first example where other shareholders (i.e., those who purchased the shorted shares) potentially receive a vote, net short put positions (i.e., those who sold the purchased puts) do not receive a vote. The short put position might be offset by hedge transactions in the market for shares, or not. As with short positions, there is the potential for inefficient strategic behavior. For example, a controlling block of shareholders could purchase large quantities of put options, and then vote for a proposal that would reduce the value of the company's shares. Alternately, any

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<sup>60</sup> The question of whether purchasers of the shares that B has sold short also will obtain the right to vote is addressed in Part III.B. Assuming they do not (or that if they do, then B will lose her vote), if there are no other derivatives transactions, there will be a net long position equal to the number of shares outstanding, regardless of the amount of shorting that occurs. (We later relax this assumption, which in fact is false, but it is irrelevant for purposes of this analysis.) Accordingly, one can argue that if all shareholders vote, their preferences can be aggregated and the result will be an efficient one, just as if only net “pure” residual shareholders had voted. Unfortunately, there is no assurance that preferences can be so aggregated, particularly when there is uncertainty as to which shareholders will exercise their votes. In the extreme case, if the pure residual shareholders are apathetic, corporate decisions could be governed by those whose interests favored reducing the value of shares. At a minimum, close votes could be decided by the balance-tipping votes of shareholders with a net short position, and hence who have interests directly contrary to the majority of shareholders. Additional explication of these issues is also contained in Part III.B.

<sup>61</sup> The example is further complicated by the possibility of B purchasing an in-the-money or out-of-the-money put option. The more the put option is out-of-the-money (or less it is in-the-money), the less B's incentives will be aligned with those of shareholders. A deep out-of-the-money option would create incentives for B to favor proposals that would radically, if temporarily, reduce the value of shares, to below the (low) strike price.

shareholder with a very large put position and a relatively small equity stake would vote for proposals that would permanently reduce the value of the company, because the increase in the put position would more than outweigh the decline in her equity position.<sup>62</sup>

Third, suppose B owns ten shares and sells ten call options on those shares.<sup>63</sup> As with puts, B's incentives differ from A's in two respects: (1) B has limited upside, which she relinquished in return for the call option premium, and therefore, other things equal, is indifferent as to decisions that would increase the value of shares; and (2) B has different short- and long-run incentives. Now B would not favor proposals that would increase the value of shares, and would also oppose any proposal that would incur a non-zero risk of a decline in the stock price in order to obtain a larger risk-adjusted increase in value. Moreover, if B sold call options on more than ten shares, she would oppose such proposals, at least in the short run and (as with puts) perhaps in the long run as well. Moreover, the differential incentives would create similar opportunities for strategic behavior as those described above.

Fourth, suppose B owns ten shares and sells ten put options on those shares. Now, B has "magnified" the incentives associated with her shares, with respect to downside risk. In other words, B will be especially against proposals that might cause the share price to decline. Again, B's incentives differ from A's in two respects: (1) B has (virtually<sup>64</sup>) unlimited downside with respect to her net short put position and hence will prefer to minimize the volatility associated with the value of shares, and (2) B has different short- and long-run incentives. Because B has sold options, B essentially has sold volatility, the key determinant of an option's value. In the short run, B will want the value of the share price to be less volatile than a "pure" shareholder would want, because the value of her option becomes more negative as volatility increases. B therefore will be more risk averse with respect to losses than would a typical shareholder.<sup>65</sup>

Fifth, suppose B owns ten shares and buys ten call options on those shares. B has thereby magnified the incentives associated with her shares, with respect to upside risk. In other words, B will be especially eager to have the corporation undertake proposals that would cause the share price to rise. Again, B's incentives differ from A's in two respects: (1) B has unlimited upside, with respect to the long call position, and therefore will prefer to maximize the volatility associated with the value of shares, and (2) B has different short- and long-run incentives. Because B has bought options, B essentially has

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<sup>62</sup> Such a stockholder might, of course, economically prefer to own only the put position; however, because ownership of the equity stake may enhance her ability to maximize the value of her put position – e.g., because she can enhance the chance of a negative corporate event by voting for it – the decrease in the value of the stock that she owns is merely a cost of ensuring her larger economic benefit.

<sup>63</sup> Such a strategy is often referred to as covered call writing.

<sup>64</sup> B's losses are limited only by the fact that the price of a share cannot decline below zero.

<sup>65</sup> This risk aversion is the opposite of that documented by numerous scholars, including most famously by Amos Tversky and Daniel Kahneman. See Amos Tversky & Daniel Kahneman, Rational Choice and the Framing of Decisions, 59 J. Bus. 251 (1986); see also Robert C. Ellickson, Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics, 65 Chi.-Kent L. Rev. 23 (1989). It is the structure of the portfolio position – not any aspect of human behavior – that generates this risk aversion.

bought volatility. In the short run, B will want the value of the share price to be more volatile than a “pure” shareholder would want, because the value of her option becomes more positive as volatility increases. B therefore will be more risk seeking with respect to gains than a typical shareholder would be. Moreover, if B’s call position was larger than her equity position (e.g., B owned 10 shares but 10,000 calls), B might substantially prefer volatility-enhancing initiatives – thereby increasing the value of her calls – even if this enhanced volatility greatly diminished the value of the corporation and its stock.

Sixth, suppose the corporation has issued bonds<sup>66</sup> in addition to stocks. A shareholder who buys bonds will have different incentives from those of a pure shareholder because of the priority of bonds in the capital structure. If one thinks of the shareholders as owning the assets of the corporation,<sup>67</sup> then the bondholders have sold a put option to the shareholders. In this conceptualization, the shareholders have the right to sell the assets to the bondholders for an exercise price corresponding to a share price of zero (i.e., the face value of the bonds). As noted above, a seller of a put option on the assets of the firm is more risk averse with respect to losses and less risk seeking with respect to gains. Accordingly, if B owned a very large portfolio of bonds, she might oppose a proposal that would increase the value of her shares due to the associated risk to her bonds. As with the put and call options examples, the differing incentives arise from optionality in the portfolio: because the bonds effectively are a short put option, they benefit from a reduction in volatility.

Seventh, a shareholder who has shorted bonds will have negative incentives similar to those of a shareholder who has shorted stocks. The major difference is that the short bond position benefits less from value-reducing proposals, and is harmed less from value-increasing proposals. The short bond position is less volatile, and the incentives of such a shareholder are to reject proposals that would increase the value of shares, and to be less risk seeking than a pure shareholder.

## 2. *Line-Drawing.*

All of the above examples are ways in which shares can be encumbered such that they would no longer face incentives similar to those of residual claimants. The assumptions of the law and economics literature on corporate voting do not hold with respect to such encumbered shares, and therefore the traditional argument in favor of giving them a vote is inapt. Instead, from an incentive perspective, such shareholders arguably should be no more entitled to voting rights than other similarly situated non-shareholders. Put another way, giving voting rights to such shareholders results in an inefficient decision making process.

Of course, shareholders can be encumbered in a variety of other economic ways as well with respect to which the argument for depriving them of voting rights is weaker. For example, shares held by managers are encumbered because managers have relatively more human capital invested in the corporation than other shareholders, and are therefore more likely to have incentives similar to those of a bondholder. Managers who also are call option holders are encumbered in that upside incentives might lead them to accept

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<sup>66</sup> A similar analysis would apply to the issuance of preferred shares or other intermediate hybrid securities.

<sup>67</sup> Alternatively, one can imagine that the bondholders own the assets of the corporation and have sold a call option to the shareholders. The analysis would lead to similar conclusions.

proposals that would increase the volatility of the firm's share price, at least in the short run, even though they would not increase the shares' value.

A similar analysis could be performed for the corporation's employees, suppliers, and others with relationships to the firm. To the extent these parties are shareholders, they may face incentives that differ from those of traditional shareholders. However, it would be very costly to undertake to make determinations as to which of these shareholders would face the appropriate incentives such that they should have votes. Instead, the cost-effective solution is to grant these shareholders voting rights, notwithstanding the fact that their incentives differ from those of a pure residual interest.

Ultimately, the question whether economically encumbered shares should be entitled to vote is an exercise in line drawing, to be resolved principally upon an analysis of transaction costs. On one hand, corporate voting should be structured so that residual claimants have the general ability to control the corporation's decisions, because they are the ones who gain or lose at the margin. This argument suggests that those shareholders with encumbered positions should not be entitled to vote. Permitting these shareholders to vote would lead to inefficient decisions, because they would favor proposals that would not maximize the value of the corporation.

On the other hand is the argument that any system of corporate voting should minimize not only agency costs, but also transaction costs. One possible explanation for the persistence of one-share/one-vote, regardless of economic encumbrance, is that the process of deciding which shareholders should be entitled to receive a vote would be too costly under most circumstances. It arguably would be quite expensive for corporations to engage in this practice on their own, especially with respect to encumbrances of employees, suppliers, and others with non-financial claims to the corporation's profits.

However, as the way shares are held has changed, it has become substantially cheaper to monitor the holdings of individuals. Indeed, brokers engage in precisely this sort of monitoring already, and the SEC has assumed this kind of monitoring is possible in recent proposals regarding the nomination of corporate directors. Commentators previously have considered the benefits and costs of having managers participate as shareholders, *i.e.*, of having managers invested in the corporation. The argument here is a corollary: depending on costs, perhaps some shareholders – including managers – should be divested instead.

We hope here to begin the discussion of where the line should be drawn. At minimum, shareholders with substantial short positions should not be entitled to vote. Such a limitation could be implemented at relatively low cost. Brokers can and do keep records for each shareholder, including details about portfolio positions. Brokers could communicate this information to share depositories and proxy firms at relatively low cost. Indeed, as we discuss in Part III.B., these institutions already should be determining whether shares are legally encumbered, and could use this information to identify shares that are economically encumbered.

Our preliminary conclusions are that corporations and their regulators should strongly consider taking away the votes of options buyers and sellers, but should not divest employees or suppliers of their votes. But whatever the conclusion, it seems clear that the assumption of shareholder homogeneity does not hold, and therefore, wherever the line is to be drawn, it should not be at one-share/one-vote.

## B. *Legal Encumbrances*

In addition to being economically encumbered, shares can be – and frequently are – legally encumbered, particularly through lending and shorting arrangements.<sup>68</sup> Lending and shorting create uncertainty about whether voting rights attach to particular shares; questions arise as to whether shareholders whose shares have been loaned out maintain their voting rights, and also whether shareholders who have purchased shorted shares acquire voting rights.<sup>69</sup> Difficulties also arise regarding the manner in which brokers vote on behalf of shareholders, particularly broker nonvotes.<sup>70</sup> These legal encumbrances have gone largely unnoticed in the literature and in practice, primarily because both shareholders and academics simply assume that they in fact maintain the voting rights attached to shares they purchase or own.<sup>71</sup>

### 1. *The Generation of Legal Encumbrances.*

Stock lending and shorting generate several important benefits, including improved market liquidity and pricing efficiency.<sup>72</sup> Although legislators periodically raise concerns about short selling, scholars generally have opposed its regulation. However, scholarly debate has centered on extant restrictions on shorting, not on the effects of shorting on voting rights.<sup>73</sup>

In 1991, the House Committee on Government Operations released a report on short selling, finding that the “effects of short selling on the securities markets are not

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<sup>68</sup> These arrangements involve very substantial numbers of shares. The average short interest on the NYSE during 2003 was approximately eight billion shares, roughly two percent of total shares. See [www.nyse.com/press](http://www.nyse.com/press).

<sup>69</sup> The practices didn’t matter until the demand for stock borrowing was spurred by new trading strategies and arbitrage, beginning in the 1980s. U.S. custodian banks began lending stocks to brokers on behalf of their clients. In these lending transactions, voting rights were transferred. Regulators in England have explicitly recognized this problem: “Stock lending involves the absolute transfer of title to both the securities lent and the collateral taken and any voting rights are transferred along with title. Stock must therefore be recalled by the lender, or collateral substituted by the borrower, if they wish to exercise voting rights attaching to particular securities.” Stock Borrowing and Lending Code of Guidance, Bank of England, December 2000, <http://www.bankofengland.co.uk/markets/stockborrowing.pdf>.

<sup>70</sup> Brokers generally are entitled to lend securities. A typical provision of margin account terms and conditions states: “[Broker] is authorized to lend any securities held on margin in my account(s) to itself as broker or to others, unless and until Ameritrade receives written notice of revocation from me.” Ameritrade Terms at Conditions at 112 (2003).

<sup>71</sup> See Henry G. Manne, *Some Theoretical Aspects of Share Voting*, 64 Colum. L. Rev. 1427 (1964).

<sup>72</sup> Securities lending not only permits shorting, but also provides liquidity for the covering of options or other arbitrage positions, and avoids delivery failures and settlement defaults. The computerized program trading and arbitrage strategies that dominate the trading of stocks globally would not be possible without securities lending.

<sup>73</sup> See, e.g., Jonathan R. Macey, Mark Mitchell, & Jeffrey Netter, *Restrictions on Short Sales: An Analysis of the Uptick Rule and its Role in View of the October 1987 Stock Market Crash*, 74 Cornell L. Rev. 799 (1989); see also Michael R. Powers, David Schizer & Martin Shubik, *Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short Sales*, available at [www.ssrn.com](http://www.ssrn.com) (2003).

widely understood,” and asking the SEC to examine the issue.<sup>74</sup> The SEC undertook to study short sale practices, but did not specifically consider the effects of short sales on corporate voting. In response to the SEC’s request for comments, a few individuals asked the SEC to clarify the circumstances under which the purchaser of shorted shares can vote.<sup>75</sup> Their expressed concern was that they did not know when they bought shares if they had been sold short or borrowed. The SEC did not address these concerns, and instead determined that no action was necessary with respect to short sales.<sup>76</sup> During the past decade, the SEC has continued its policy of not regulating the voting of shares sold short.<sup>77</sup>

The tension between shorting and lending on one hand, and voting rights on the other, arises from the complex interaction of clearing and brokerage, with shares being held in “street name” on behalf of shareholders through brokers, who are members of, and in turn hold shares through, the Depository Trust & Clearing Corporation, the primary holder of record (with the nominee name Cede and Co.) for most securities.<sup>78</sup> Through a subsidiary, the National Securities Clearing Corporation, DTCC provides to its members the Continuous Net Settlement System, an automated book-entry accounting system that centralized the settlement of securities transactions.<sup>79</sup> DTCC members settle

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<sup>74</sup> Short-Selling Activity in the Stock Market: Market Effects and the Need for Regulation (Part 1) (House Report), H.R. Rep. No. 102-414 (1991), reprinted in CCH Federal Securities Law Reports Number 1483 Part II (1992).

<sup>75</sup> See Letter from Don E. Sprague to the SEC, File No. S7-24-99, Jul. 8, 2001 (available at <http://www.sec.gov/rules/concept/s72499/sprague1.txt>) (“When an investor purchases a short sold stock, they must be informed that they do not have voting rights since they purchased short sold stock. The purchaser must be informed that the short may be covered at a later date and they will then hold real stock with voting rights.”).

<sup>76</sup> The SEC originally sought comments on the practice of “street name” voting in 1977. See SEC Release No. 34-13482 (Apr. 28, 1977); see also SEC Release No. 34-13901 (Aug. 29, 1977). The source of the SEC’s initial concern was a report detailing the voting practices of brokers holding securities on behalf of their customers. See The Final Report of the Securities and Exchange Commission on the Practice of Recording the Ownership of Securities in the Records of the Issuer in Other Than the Name of the Beneficial Owner of Such Securities 13-15 (December 3, 1976). The SEC noted in this report that brokers were voting shares without voting instructions, invariably in favor of management, but concluded that this practice was proper, in part because NYSE Rule 452 contained sufficient limitations on such voting. *Id.* at 8. It does not appear that this view has changed.

<sup>77</sup> Recently, the SEC has proposed changes in two areas related to shareholder voting: enhanced disclosure related to committees nominating director candidates and enhanced access of certain shareholders to the director nomination process. See SEC Release No. 34-48301 (Aug. 8, 2003) (disclosure); SEC Release No. 34-48626 (Oct. 14, 2003) (access). The enhanced access proposal involves triggering a nomination process at the request of a “one percent” shareholder, and permitting nomination by a “five percent” shareholder (for a two-year period). Such a shareholder would be required to certify compliance with such a threshold (e.g., “By signing below, I further certify that \_\_\_% of the securities referred to above have been held continuously for at least 2 years.”)

<sup>78</sup> See <http://www.dtcc.com/>. DTCC’s clients include more than 2,500 brokers, dealers, banks, mutual funds, insurance carriers, and other organizations, each of whom has an account at DTCC.

<sup>79</sup> See <http://www.dtcc.com/ProductsAndServices/clearing/cns.html>.

their transactions with NSCC through CNS three days after the trade date, the date on which their clients buy or sell securities. CNS long positions represent securities owed by NSCC to member participants; CNS short positions represent securities owed by members to NSCC.

For short positions, NSCC has established a Stock Borrow Program, through which member participants may lend excess securities in their DTCC account to NSCC's account at DTCC. NSCC has implemented various procedures to ensure that its short sale delivery obligations through CNS are satisfied, if they cannot be satisfied through normal delivery of shares. NSCC pays overnight interest to members who lend securities to NSCC to cover temporary shortfalls. Securities on loan to NSCC are recorded as long positions in a special CNS account dedicated to the member's Stock Borrow Program.

Because DTCC (through Cede and Co.) is the holder of record for most securities, it also is entitled to the voting rights associated with those securities. DTCC passes on its voting rights to official record holders (e.g., brokers) through an omnibus proxy listing each member participant's closing balance as of the record date, and thereby assigning the voting rights associated with shares as of the record date. A broker then assigns the voting rights to individual shareholders, who either vote (in person or by proxy) or not.<sup>80</sup>

This complex process interacts with lending and shorting practices to produce surprising results. For example, when individuals buy or own shares, they typically have no way of knowing whether the shares have been loaned or shorted.<sup>81</sup> Short sellers borrow shares from brokers, who obtain those shares from other shareholders' margin accounts.<sup>82</sup> Whereas the shorting party can, and does, undertake to pay any dividend declared by the corporation, the shorting party cannot similarly undertake to transfer voting rights.<sup>83</sup> Consequently, because there are only a finite number of votes, when a

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<sup>80</sup> Brokers enter into agreements with proxy agent and solicitation firms to assist with the distribution and counting of shareholder proxies. Scholars have been critical of the role of these firms (which include, most prominently, ADP Shareholder Services and Institutional Shareholder Services, and are not regulated by SEC) in the voting process. See Dale A. Oesterle & Alan R. Palmiter, *Judicial Schizophrenia in Shareholder Voting*, 79 Iowa L. Rev. 485, 510-11 (1994). ADP has been accused of miscounting proxies and sending proxies out late (or not at all), and institutional investors have urged the SEC to review proxy distribution practices, to little avail.

<sup>81</sup> In order for a shareholder to assure she will be able to vote shares, she must either not have them in a margin account (i.e., not permit the broker to lend the shares) or she must ask the broker to put the shares into the cash side of her account before the record date of the vote. Although individuals can prevent shares from being loaned by following this approach, they still will not know whether the shares they hold in a cash account previously were loaned and shorted.

<sup>82</sup> The shorting shareholder's account is credited with the proceeds from the sale. Depending on the relationship between the shorting party and the broker, the shorting party may receive margin interest on the funds from the short sale. If the shareholder is a good customer or has collateral in the account, the broker may agree to more favorable interest payment terms. For shorting, institutional investors bid down the interest rate to low levels. They have a comparative advantage over individuals in selling short. If the stock price increases, the broker typically requires the shorting party to post additional collateral.

<sup>83</sup> In other words, all share positions are entitled to both dividends and voting rights. The corporation avoids paying additional dividends on loaned and shorted shares by having the shorting party pay dividends to the shareholder. Cash is fungible so that a shorting party can pay dividends from other assets. But voting is not fungible and a shorting party with no



shareholder permits a share to be borrowed for shorting, she essentially creates a new shareholder. Share lending thereby creates the illusion that there are more shares owned beneficially than are actually registered.<sup>84</sup>

The last buyer of shares in the chain of lending and shorting is the final shareholder of record, and only that person technically should have the right to vote.<sup>85</sup> All previous beneficial owners of shares in the chain technically are not shareholders of record, and therefore should not have a voting right. In this way, predecessor shares (i.e., holders of shares that have been loaned out) can be said to be “legally encumbered.” As with economically encumbered shares, legally encumbered shares arguably should not have a vote.<sup>86</sup>

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corresponding shares entitled to vote will not be able to “pay” a vote to a share purchaser. Nor will the corporation want to dilute votes by permitting new shares to vote. As a result, both the initial owner of a share and also the later purchaser of a loaned and shorted share (and any other purchasers of loaned shares, depending on how many times the shares are loaned) each will expect to have a vote. This situation is problematic; if every long share position voted, there would be more votes than shares. See Canada Business Corporations Act Discussion Paper: Shareholder Communications and Proxy Solicitation Rules ¶ 75 at 17 (August 1995) (available at <http://strategis.ic.gc.ca/pics/cl/sc-eng.pdf>) (“The reality is that more than one proxy can be issued for the same shares when two or more shareholders feel that they have the right to vote them. This, in turn, can cause the number of proxies delivered by an intermediary to exceed the number of shares registered in the name of that intermediary. This may lead to adjustments to proxy tabulated votes that would affect a voting decision.”); see also *id.* ¶ 77 at 18 (“Because of the large volume of loaned securities in the marketplace on any given day, the possibility of overvoting seems always to be present.”).

<sup>84</sup> Suppose A buys a share, which is then loaned through A’s broker to a shorting party. The shorting party sells the share to B. The share again is loaned through to another shorting party, who sells to C. And so on. Each buyer considers herself to be a shareholder. Yet at DTCC, there is only one share, with only one vote.

<sup>85</sup> SEC and NYSE rules provide that one may vote only shares in one’s “possession and control.” See SEC Rule 15c3-3; NYSE Rule 452 (“A member organization shall give or authorize the giving of a proxy for stock registered in its name, or in the name of its nominee, at the direction of the beneficial owner. If the stock is not in the control or possession of the member organization, satisfactory proof of the beneficial ownership as of the record date may be required.”). Accordingly, the lender formally loses the right to vote shares that are loaned because she is not in “possession and control” of those shares. The specifics are governed by standardized brokerage industry agreements, although an informal survey of brokers indicates that these agreements are not followed.

<sup>86</sup> The opposite result – or at least a variant – arises from a “naked short,” in which the shorting party sells a share without first borrowing the share. In such cases, the buyer of the share from the short should not have a vote because she has essentially purchased a synthetic share, which does not have any voting rights borrowed from an actual share. The fact that buyers have no way of knowing whether they have purchased their share from a short or from an actual owner only further complicates matters. Naked short selling is prohibited by the major exchanges, but is pervasive in the over the counter market, and the SEC is presently considering a regulation to prohibit the practice. See SEC Release No. 34-48709 (Nov. 3, 2003) (available at <http://www.sec.gov/rules/proposed/34-48709.htm>).

Two conditions must be satisfied in order for legally encumbered shares to be voted, as they currently are, without leading to overvoting.<sup>87</sup> First, only a fraction of shareholders can vote. If every shareholder voted, then brokers would be forced to deprive legally encumbered shares of their vote. Second, brokers must reallocate votes among shares.<sup>88</sup> When two parties each submit proxies related to the same share, the broker must find (or borrow) a nonvoting share and allocate that vote to one of the voting parties. This fictional reallocation of shares prevents more than one vote being attributed to an individual share.<sup>89</sup> If brokers did not reallocate shares in this manner, shareholders interested in preserving their voting rights would withdraw their shares, exacerbating any reduction in short-term liquidity.

Before the introduction of single-stock futures,<sup>90</sup> an argument could be made that liquidity concerns justified substituting the actual legal rights of shareholders to vote with the fictional regime described above. But such an argument is inapplicable today. Instead, any liquidity effects from denying the vote of legally encumbered shares would be minimized by the ability of parties to sell single-stock futures to create a economic short share position. In fact, restricting – or even halting – lending and shorting of shares might reduce costs and improve liquidity, by forcing investors away from the path-

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<sup>87</sup> Before the introduction of the DTCC procedures described above, overvoting was a serious problem (and remains a problem outside the United States – Canada is one example). Since the 1980s, stock lending transactions have been recorded at DTCC specifically as borrows and loans, making overvoting technically impossible (at least DTCC; it remains possible at the broker level). DTCC submits reports to its members twice per day indicating which positions are shares and which are loans. It is up to the broker (or the broker's agency) to send proxy materials to, and to submit votes only on behalf of, only shareholders of record on the record date. In other words, the risk is not of formal overvoting, which DTCC procedures prevent, but of creating the expectations of a vote among more shares than there are votes, as well as ensuring that any votes cast are voted by individuals actually entitled to do so.

<sup>88</sup> Anecdotal evidence suggests that brokers do not take care to ensure that each share is voted only once, or that shareholders with shares in margin accounts are informed that their shares have been loaned out and that they might not have a vote (even though they have been sent a proxy and proxy materials). Brokers instead send voting proxies to all shareholders of record, regardless of whether the shares they hold have been loaned out and sold short. See Letter from Bill Hawes to the SEC, File No. S7-24-99, Dec. 8, 2000 (available at <http://www.sec.gov/rules/concept/s72499/hawes1.txt>) (“Currently the issue of voting rights for short-sold shares is not regulated by the SEC, and the common practice by brokerage institutions is to forward voting proxies to all shareholders of record, even if their shares have been (in all or part) loaned out and sold short. This practice leads to the situation in which more shares are eligible for a proxy vote than are currently outstanding for the company, due to the diluting effect of short-selling. The presence of these additional votes could possibly distort the results of shareholder voting.”). In addition, brokers typically do not disallow votes by legally encumbered shares. If they did, shareholders who cared about voting would not permit their shares to be loaned, and market liquidity would decline.

<sup>89</sup> If brokers did so, then fewer shareholders would permit their shares to be loaned, and liquidity would suffer. Alternatively, shareholders would transfer shares from margin to cash accounts before the record date, to preserve their votes, leading to sharp declines in liquidity just prior to the record date.

<sup>90</sup> Single-stock futures were illegal until passage of the Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

dependent lending and shorting approach to a more sensible, lower-cost approach they otherwise might not undertake (because switching costs are too high). Now that single-stock futures are available, regulators could encourage their use, establish voting practices consistent with law, and reduce costs by restricting or prohibiting lending and shorting, and encourage trading of economically equivalent single-stock futures. Indeed, because the margin requirements for single-stock futures are lower than those for shorting, the markets likely would shift from shorting if differential costs were introduced.

## 2. *The Effect of Legal Encumbrances.*

Perhaps the most remarkable aspect of legally encumbered shares is how few shareholders and brokers understand the potential limitations on voting. For example, there is no price differential between shares that have been loaned and shares that have not. Indeed, there is no effort made to distinguish among shares based on whether they have been loaned. These facts indicate either that shareholders do not understand the process of loaning shares, or that they do not care. If shareholders understood and cared about voting rights, a market practice easily could evolve where loaned shares would carry a particular label, so that shareholders would know whether someone else is holding their shares. But no such practice exists.

If the voting of legally encumbered shares were restricted, shareholders would be more likely to protect their votes, to the extent they cared about them, by calling shares in from margin accounts to cash accounts, from which brokers are not permitted to loan. Brokers then would not need to redistribute votes surreptitiously or cancel the votes of shareholders whose shares have been loaned out. Voting restrictions on legally encumbered shares could be imposed either by regulators or by the market; if regulators simply enforced basic contract law principles governing voting rights, market practices likely would evolve to prevent vote shifting.

As with economically encumbered shares, legally encumbered shares thus undermine the efficiency rationale for one-share/one-vote.<sup>91</sup> If the original shareholder is not economically encumbered, she – according to the standard law and economics argument – should have a voting right. Yet each share carries only one vote. The current approach of giving such shareholders a phantom vote works only because so few shareholders vote, and therefore current practice is an unstable equilibrium. The one-share/one-vote rule is not applied to give each share one vote.

Further, like the voting of economically encumbered shares, the voting of legally encumbered shares is subject to manipulation. Indeed, the practices of lending and shorting can facilitate such activities. Suppose a company has issued 100 shares, and that A owns 20 of those shares and has an 80 share short position. Further suppose that A would like to press for a vote opposed by all of the other shareholders (and the holders of the 80 shares purchased from A in the short sale, which were borrowed from the original shareholders), because it will depress the share price. A can borrow and short an

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<sup>91</sup> They also present systemic concerns. Recently, a clearing firm nearly failed after one of its broker clients failed to deliver \$60 million in exchange for borrowed stock. See *Securities & Exchange Comm'n v. D'Angelo* (Complaint filed Sept. 11, 2003) (available at <http://www.sec.gov/litigation/complaints/comp18344.htm>). MJK Clearing suspended operations when Native Nations Securities failed to deliver cash for borrowed stock in Genesis Intermedia. Ten NYSE member firms were left holding stock in the firm. *Id.*

additional 80 shares, buying back all 80 of those shares through a related party. A would still have a net negative position in the corporation's shares. But now A arguably would have not only the 20 votes associated with her original share position, but an additional 80 votes associated with the shares purchased from her own shorting transactions. There are now 180 shares that arguably have votes, of which A holds 100. Even if every share voted, an unlikely event given widespread shareholder apathy, A would win a majority.

Such practices might be difficult to orchestrate in the shares of the largest publicly held corporations, but thinly traded stocks are more easily susceptible to such activity. If shareholders believe such activity might take place, they will be less willing to purchase such stocks, resulting in a higher cost of capital overall and a less efficient market. If only the final shareholder of record were permitted to vote, these incentives for manipulation would not exist.<sup>92</sup>

A final problem associated with the current system of voting is the way in which brokers vote on non-discretionary matters and submit nonvotes. Shares can be thought to be legally encumbered in additional ways, based on the exercise power of the broker to vote those shares.

Recall that the voting of "street name" shares by brokers is governed by the various stock exchanges.<sup>93</sup> The exchanges give brokers discretion to vote street name stock, unless the beneficial owner gives specific instructions to the contrary or the vote is important.<sup>94</sup> These rules developed as more shares became held in street name, and managers expressed concern that if brokers were not permitted to vote shares on behalf of clients, few corporations could satisfy their quorum requirements (generally set at fifty percent of the eligible votes).<sup>95</sup> Under Delaware law, abstentions count toward a

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<sup>92</sup> On the other hand, parties can use single-stock futures to purchase votes, by purchasing shares and simultaneously selling an equivalent number of single-stock futures. Accordingly, a legally encumbered share rule is necessary, but not sufficient, to prevent such manipulation. To deter such practices, economically encumbered shares (e.g., a share plus the sale of a single-stock futures) also should be deprived of votes.

<sup>93</sup> See 2 N.Y.S.E. Guide at 2451-2452; 2 Am. Stock Ex. Guide at 9528-9529; NASD Rules of Fair Practice, Art. III, § 1, Interpretation. 05, Section 4, NASD Manual 2151.05 at 2038. NYSE Rule 452 states: "A member organization may give or authorize the giving of a proxy to vote any stock registered in its name, or in the name of its nominee, if such member organization holds such stock as executor, administrator, guardian, trustee, or in a similar representative or fiduciary capacity with authority to vote." Neither state nor federal law sets forth specific rules governing the relationship between the beneficial owner of shares and her broker, or record owner. See *American Hardware Corp. v. Savage Arms Corp.*, 136 A.2d 690 (Del. 1957).

<sup>94</sup> For example, a merger is considered an important event, and brokers are not permitted to vote at their discretion for or against a merger. See, e.g., New York Stock Exchange Rule 452.11 ("Generally speaking, a member organization may not give a proxy to vote without instructions from beneficial owners when the matter to be voted upon: . . . (3) relates to a merger . . .")

<sup>95</sup> Delaware corporation law states a quorum is "a majority of the shares entitled to vote, present in person or by proxy" unless the statute, charter, or by-laws provide otherwise. The statute provides that the charter and by-laws may not lower the quorum below one-third of shareholders entitled to vote. Obtaining a quorum is no longer as difficult for most large public corporations, because most shares are held by institutions, many of which have a fiduciary duty to vote, and typically do.

quorum.<sup>96</sup> Thus, shareholders who are present at a meeting (through their broker) are properly counted in determining a quorum even if they do not vote their shares.

Votes on proxy ballots are separated into matters that are “routine” or “non-routine.” For routine proposals, brokers have discretion and may vote shares held in street name if investors fail to vote (or the broker may abstain from voting). For non-routine proposals, brokers lack discretion to vote shares, but may submit a “nonvote.” Abstentions are counted as votes against any proposal that must pass with an affirmative vote of the majority of the votes cast. Non-votes are counted as votes against any proposal that must pass with an affirmative vote of a majority of all outstanding shares.

These voting rules make it more difficult for shareholder proposals to pass, and favor management to the extent brokers are voting in place of shareholders. For example, Jennifer E. Bethel and Stuart L. Gillan found that routine management proposals receive eight percent more favorable votes than non-routine proposals, and 10.3 percent higher voter turnout.<sup>97</sup> Anecdotal evidence, including letters to the SEC, also supports the notion that the practice of broker voting favors management over shareholders.<sup>98</sup>

Although the SEC has expressed concern that management’s abuse of broker voting rules was not only making it more difficult for shareholder proposals to pass, but also was resulting in some shareholder proposals drawing more yes votes than no votes,

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<sup>96</sup> In 1988, the Delaware Supreme Court interpreted Section 216 of the Delaware General Corporation Law to provide that the number of shares “counted” for quorum purposes need not necessarily be the same as the number of shares required to be “present” for voting purposes. See Berlin v. Emerald Partners, 552 A.2d 482 (Del. 1988). Section 216 provides in relevant part: “Subject to this chapter in respect of the vote that shall be required for a specified action, the certificate of incorporation or bylaws of any corporation authorized to issue stock may specify the number of shares and/or the amount of other securities having voting power the holders of which shall be present or represented by proxy at any meeting in order to constitute a quorum for, and the votes that shall be necessary for, the transaction of any business, but in no event shall a quorum consist of less than one-third of the shares entitled to vote at the meeting.” 8 Del. C. § 216 (Supp. 1988).

<sup>97</sup> See Jennifer E. Bethel & Stuart L. Gillan, The Impact of the Institutional and Regulatory Environment on Shareholder Voting, 34 Fin. Mgmt. 29, 29-54 (2002); see also James Hanks Jr., Disclosure of Vote Requirements and the Treatment of Abstentions and Broker Non-Votes Under the Proxy Rules, 12 Insights: Corporate & Securities Law Advisor 24-28 (1999).

<sup>98</sup> “Uninstructed broker votes significantly distort the voting process. Brokers routinely deliver votes overwhelmingly in favor of management on issues of increasing importance to shareholders – without ever consulting their clients. Investors no longer view many formerly mundane votes, such as election of directors and ratification of auditors, as routine votes, and yet the NYSE continues to permit broker votes on these issues. The one rationale purporting to justify uninstructed broker votes – the need to meet a quorum – has become open to question in light of recent research. If the NYSE inquiry suggests a need to continue uninstructed broker votes for quorum purposes, the Exchange should limit broker voting solely to quorum votes.” Public Comment of Institutional Shareholder Services to SEC dated October 31, 2002 (available at <http://www.sec.gov/rules/sro/nyse200246/pmcgurn1.htm>). In 1998, brokers cast votes to make the margin of victory for more than half of 285 stock plans that faced significant opposition. In one vote in 1999, Venator reported 6.1 million broker nonvotes as present on two proposals where exchange rules prevented brokers from voting. David Henry, Shareholder Votes Fall Through Loophole, USA Today, Aug. 26, 1999 (citing study by Strategic Compensation Research Associates).

but still losing, the SEC has not attempted substantive regulation in this area (in large part because of the judicial finding that the SEC had exceeded its statutory authority in promulgating Rule 19c-4). Instead, since 1993 federal regulations have required registrants to disclose details of their voting procedures, including the vote counting method and the effect of abstentions and broker nonvotes on shareholder proposals.<sup>99</sup> Corporations now typically disclose to shareholders that they must obtain a majority of shares voting and abstaining to prevail on a proposal.<sup>100</sup> The rationale for the disclosure approach is similar to the efficient market rationale assumed in other areas of securities regulation.

As with practices related to other encumbered shares, broker voting practices are subject to manipulation and do not reflect overall shareholder preferences. For example, managers might state that a proposal required a majority of shares “present” at the shareholders’ meeting. According to this formulation, if a shareholder did not vote, but her broker was “present,” her votes would be counted in the denominator, making it more difficult for a proposal to pass. Suppose there are 100 shares outstanding, all held in street name, half of which are voted. Further suppose there is a shareholder proposal favored by the vast majority of shareholders, but opposed by management (and brokers). Of the 50 shareholder votes, 49 are in favor of the proposal; only one is against. The 50 shares that are not voted, but held in street name, are counted as nonvotes. The proposal fails 51 to 49.

The New York Stock Exchange recently has considered changes broker voting rules with respect to shareholder approval of equity compensation plans and director nomination procedures. The responses to the compensation proposal indicate that corporations and institutional investors generally oppose changes to the rules, while individual shareholders remain largely unaware of broker voting practices.<sup>101</sup> Similar arguments have arisen in the debate about shareholder nominations of corporate

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<sup>99</sup> 17 C.F.R. 14a-101 Items 21 (a)-(b) (1993); 17 C.F.R. Schedule 14A, Item 21(a)-(b).

<sup>100</sup> If markets were efficient with respect to information about voting, this disclosure would be sufficient to remedy any flaws in the system of broker voting.

<sup>101</sup> Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Shareholder Approval of Equity Compensation Plans and the Voting of Proxies, SEC Release No. 34-46620 (Oct. 8, 2002): “B. Elimination of Broker Voting. The Exchange represents that the institutional investor community gave strong support to this proposal. Many large companies, however, strongly urged the NYSE to maintain its existing rules, fearing primarily the increased proxy costs and increased uncertainty that the proposed change would entail. Large and small companies alike cited quorum difficulties and solicitation expenses that result when brokers are not allowed to vote uninstructed shares after a 10-day period. One such commentator warned that because of retail investor confusion about voting mechanics, there is a risk that the elimination of the discretionary broker vote will disenfranchise investors if not accompanied by an aggressive and vigorous program to educate them about how to vote their shares. Many commentators also expressed concern that institutional shareholders may simply vote their shares in accordance with strict internal or third-party guidelines or policies, rather than giving each plan individual consideration. One organization suggested proportional or mirror voting by brokers of uninstructed shares.”). In a 1998 survey of individual investors, 77 percent were unaware that brokers could vote their shares

directors.<sup>102</sup> The above discussion suggests that these proposals should be responsive to the limitations on voting that arise from the encumbrances of shares.

#### IV. NON-SHARE POSITIONS AND VOTING RIGHTS

In Part III, we demonstrated that shares can be encumbered economically or legally, and therefore arguably should not be entitled to vote, at least in certain instances. In this Part, we consider the converse claim as to non-share positions with economic interests identical to that of a pure residual interest holder. The pure residual interest holder is entitled to a vote based on her economic incentives; we consider whether economically equivalent non-share positions also should have votes.

One powerful argument against giving a vote to non-shareholders is that they have no direct relationship with the corporation. They have not purchased any stake in the corporation, and therefore should not be involved in its governance. At first glance, this argument might seem dispositive. After all, shouldn't the lack of a formal link with the corporation be more important than the economic incentives facing the investor? Moreover, if votes were allocated to anyone facing the incentives of an economic residual position, the number of votes would be indeterminate and might become unmanageably large; the corporation would lose control of the voting process and managers and shareholders would find it difficult to know which constituents would control the voting process at a particular point. Voting would be even more susceptible to manipulation than it already is.

Notwithstanding this argument, under certain circumstances, non-shareholders with residual exposure to the company's stock price are more appropriately in the role of "shareholders" – with a vote – than (encumbered) shareholders themselves. For example, it is conceivable that every share could be so encumbered that no shareholder should be entitled to vote. Suppose that every shareholder also had a short position not involving a short sale (i.e., involving options or single-stock futures).<sup>103</sup> The true residual claims to the corporation's cash flows in such a setting would have been shifted away from shares to derivative contracts, so that the parties in the economic residual position were no longer shareholders. If one "real" shareholder were to unwind her short position, so that she was in a "pure" residual position, she would prefer to assign votes to the non-shareholders with residual-like interests than to other shareholders. In other words,

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<sup>102</sup> See Robert C. Pozen, Institutional Perspective on Shareholder Nominations of Corporate Directors, Harvard Olin Discussion Paper No. 429 (2003); Lucian Bebchuk, The Case for Shareholder Access to the Ballot, 59 *Bus. Lawyer* 43 (2003); Martin Lipton & Steven Rosenblum, Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come, 59 *Bus. Lawyer* 67 (2003).

<sup>103</sup> Consider a simple example of a corporation with 100 shares. Suppose all of the shares are held by individuals who also have sold a like number of single-stock futures, so that their residual economic interest in the shares is cancelled by their single-stock futures position. Then, all of the shareholders of the corporation would be indifferent to any actions taken by the corporation. Instead, the holders of single-stock futures would have the greatest economic interest. They would be in the economic position shareholders are assumed to hold: these non-shareholders would receive most of the marginal gains, and incur most of the marginal losses, of the corporation's decisions. Accordingly, these non-shareholders – rather than the actual shareholders – should have the appropriate incentives to make discretionary decisions.

depending on the degree and type of trading, the economic residual interest of a corporation might not reside with shareholders (contrary to Easterbrook & Fischel's assumptions); instead, it could reside with holders of options portfolios, single-stock futures, or other equity derivatives.

Moreover, the number of non-shareholders with votes could be limited by permitting only those non-shareholders who can trace their positions directly to a voting share. For example, the counterparty to a short position executed by a true shareholder would be entitled to a vote, but the counterparty to a short position executed by someone who did not have the legal right to vote would not (e.g., if that share were legally encumbered). If the short position were executed on an exchange, the exchange could "acquire" only the number of votes that could be traced to the shorting party. For example, a single-stock futures exchange might trade millions of futures contracts, but only a handful of contracts that were entitled to vote. Just as shares could be labeled as loaned or not, single-stock futures could be labeled as entitled to vote or not.

In other words, the objection to giving a vote to non-shareholders with an economic residual interest is different from that typically given in the literature. Instead, such parties do not receive a vote, notwithstanding their residual position, because the cost of tracing individual positions to individual votes is too high. It is unclear whether the cost in fact is too high today, although the fact that corporations do not permit (or encourage) the shifting of votes to derivatives contracts is some evidence of the cost. Nevertheless, as the costs of financial contracting continue to decline, it will at some point become cost effective to assign votes to an economic residual interest, regardless of that interest's connection to the corporation, so long as the interest can be traced to a voting right, so that the number of votes does not exceed the number of shares.

If it is too costly to find the residual interest most directly connected to the corporation (e.g., through the purchase of shorted shares), it then would be an efficient solution to give shareholders a vote, even though their economic incentives are not the same as the residual interest. But this rationale for voting practices is quite different from that articulated in the literature. Instead, this reasoning augurs in favor of giving votes to shareholders in spite of their economic incentives.

Moreover, a firm's capital structure affects the assigning of votes, so that non-shareholders in one firm can occupy the equivalent position of shareholders of an identical firm (except for capital structure). It would seem odd to assign votes to one group of shareholders, but not to an equivalent group of non-shareholders, merely because of form. Indeed, if the law and economics argument about allocation of voting rights is correct, the assigning of votes should be invariant to capital structure. But if the assigning of votes is invariant to capital structure, then the voting rule cannot be one-share/one-vote.

To see this, we recharacterize the above argument, first in terms of a firm with only shares in its capital structure. There are at least two nonarbitrary ways to assign votes. First, as Easterbrook and Fischel suggest, each share can receive one vote. But then, shareholders can engage in financial engineering to end up with something different from a vote, so that economic and voting interests are not aligned. Second, each *net* share can receive one vote. In other words, anyone with a net share position receives a vote, regardless of their portfolio. Because financial engineering is zero sum, the number



of net shares will equal the number of shares issued and outstanding. This is true even if the holders of the shares do not actually have a vote.

For example, suppose there are 100 shares outstanding, and an active market for shorting and single-stock futures. Investors A(1) through A(100) each buy one share and short one share. The investors short shares by borrowing from brokerage firm B, which hedges its long position of 100 shares by entering into 100 short single-stock futures contracts with investors C(1) through C(100), who each enter into one long single-stock futures contract (they are the investors whose financial contracts can be directly traced to a shareholder of the corporation). As previously noted, in the traditional model, A(1) through A(100) would have the votes, even though they have no interest in maximizing the value of the firm. But to align voting and economic interests, the legal rule should allocate the vote to investors C(1) through C(100).

The number of net shares equals the number of shares issued because the arbitrage transactions are zero sum. Neither shorting nor transacting in single-stock futures creates a new claim on the cash flows of the firm. Rather, the firm creates a finite set of claims, which then are reallocated through financial engineering. In other words, whoever is left holding a “share-like” claim on the firm is the residual interest holder, not the (potentially encumbered) shareholders. Put another way, the “average” holder of the firm’s capital should receive a vote, not the party who happens to have purchased a share.<sup>104</sup>

Second, consider the complications associated with the allocation of votes in corporations with a more complex capital structure. Equity-only firms have clear holders of the economic residual interest, and those net residual interest holders are “relatively” homogeneous, at least in that each of them has an economically equivalent payoff profile. Now, consider a firm with equity and debt. Now one-share/one-vote makes even less sense, because some shareholders also are debtholders.

Allocating votes to a net residual holder also becomes more difficult. What if the “average” holder of a firm’s capital really has net one share plus net one bond? Should the holder of a net share receive a vote if she also owns a bond?

In put-call parity terms, issuing a bond is like buying a put option (which is equivalent economically to shorting a share, buying a call and lending). This should subtract votes from the shares issued, in proportion to the value of the short position associated with the put option. In other words, the shareholder, by giving up an option, should also have given up a non-linear voting stake, depending on several variables, including most importantly the volatility of the underlying cash flows of the corporation.<sup>105</sup>

The example becomes even more difficult if, as is typical of most public corporations, options are part of the capital structure. Consider two firms that are economically equivalent in every way except capital structure. Equity Inc. has \$1 million of warrants and \$10 million of equity. Debt Inc. has \$1 million of equity and \$10 million of debt. How should voting be allocated? If the rule allocates votes to equity holders (or

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<sup>104</sup> Of course, it might be costly to find the true residual interest holders. A one-share/one-vote rule would be justified if the cost of allocating votes to true residual holders exceeds the benefits. However, again, the rationale would be based on costs, not incentives.

<sup>105</sup> See Frank Partnoy, *Adding Derivatives to the Corporate Law Mix*, 34 Georgia L. Rev. 599, 603-05 (2000).

net equity holders), then Equity Inc. and Debt Inc. will make very different decisions (Equity Inc. will be more conservative; Debt Inc. will be more aggressive). In other words, the more debt a company has, the more shareholders are advantaged by the vote, because they are obtaining more voting control relative to their economic interest. At the extreme, a highly leveraged corporation could be controlled by shareholders who committed very little capital.

To the extent holders of shares, bonds, and options can be thought of as holding equivalent economic positions, depending on the corporations' capital structure, there should be a consistent theory of allocating voting rights that matches their economic residual position to their votes. One solution would be to value the "delta" (i.e., the share equivalent value of the option) of the optionality in the position (either that associated with a warrant, or the economically equivalent option associated with a bond), and add that "delta" value to the residual amount. From a theoretical perspective, there is an established net residual interest at the time of issuance. This method of allocating votes depends on several variables, making the number of votes indeterminate and subject to change over time.<sup>106</sup> Allocating votes under such a system, although theoretically defensible, would be prohibitively expensive.<sup>107</sup> Again, the rationale for one-share/one-vote would be one of cost, not incentives.

Finally, consider what might seem an esoteric point, but is actually quite a common problem in practice. Suppose Firm A has issued shares, and Firm B issues new financial instruments whose value is based on the value of Firm A's shares. If Firm B hedged the new issue, the transactions would zero sum, and it wouldn't affect the above arguments or the available quantum of voting rights. But what if Firm B didn't hedge, and instead raised capital by effectively issuing new Firm A shares? Then there would be more Firm A shares on a net basis. The "average" holder of Firm A capital in the market would have more shares. In order to match the voting and economic interest, these new net positions arguably should receive a vote, too.<sup>108</sup> Ignoring such transactions ultimately

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<sup>106</sup> From a theoretical perspective, one needs to consider not only how financial engineering changes the position of various shareholders, but also the initial position of the holders of capital of the firm (i.e., are there just shareholders, or are there bonds, options, and other hybrid instruments, too). In other words, the issue is not only heterogeneity; it also is: what is the net position of the holders of a firm's capital, the position that will remain (net) even after all the financial contracting? That net position is what should be matched with voting rights, but it depends on the firm's capital structure, and therefore the way a firm allocates its votes has to depend on its capital structure, too.

<sup>107</sup> But we actually make such calculations in other areas: insider trading rules as they relate to options, disclosure related to options, "net long positions" in the Short Tender Rule and in bond sales. See, e.g., Ownership Reports and Trading by Officers, Directors and Principal Security Holders, SEC Release Nos. 34-28869, 35-25254, IC-17991 (Feb. 8, 1991) (options insider trading rules); Disclosure of Equity Compensation Plan Information, SEC Release Nos. 33-8048, 34-45189 (Dec. 21, 2001) (options disclosure); Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules Thereunder to Trading in Security Futures Products, SEC Release Nos. 33-8107, 34-46101 (Jun. 21, 2002) (Short Tender Rule).

<sup>108</sup> Note that firms take similar actions within their own capital structure by issuing "tracking stock," whose returns depend only on the cash flows of a subsidiary or business line of the corporation; such tracking stock typically does not have a vote. See Jeffrey J. Haas,

is a decision to allocate votes to stocks, instead of to bonds and options, based on transaction costs.

The above discussion has two purposes. First, it shows that one-share/one-vote is inconsistent with matching voting rights to the economic residual interest in a corporation's cash flows, in numerous complex ways. Second, it shows that the rationale for one-share/one-vote is not based on economic incentives, but rather on transaction costs. Where financial innovation is sufficiently advanced, so that the costs are not too great, parties engage in transactions to more closely approximate the theoretical possibilities articulated above. Rules have not developed to prevent them from doing so, even though the pressure is away from one-share/one vote.<sup>109</sup>

## V. THE INEFFICIENCY OF ONE-SHARE/ONE-VOTE

Because the assumptions in the literature on corporate voting do not hold, the rules governing corporate voting – specifically one-share/one-vote rules, which assume shareholder homogeneity – are inefficient. In this Part, we assess the suboptimal consequences of specific areas of substantive law that depend on these assumptions. Inefficiencies arise in part from financial innovation, as sophisticated parties can, and do, engage in various types of arbitrage strategies to the detriment of pure residual claimants.

There are numerous instances of such suboptimal rules. For example, the quorum rules of corporate voting and the percentage-based rules of securities law are inefficient, because they erroneously assume shares are not encumbered.<sup>110</sup> More critically, holders of encumbered shares engage in arbitrage strategies related to these rules that weaken the efficiency rationale for one-share/one-vote. Below, we focus on two of the most striking ways in which these inefficiencies are manifest, which we call “voting arbitrage” and “litigation arbitrage.”

### A. *Voting Arbitrage*

Voting arbitrage occurs when parties with encumbered shares are permitted to vote notwithstanding the disparity between their economic incentives and those of other

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Directorial Fiduciary Duties in a Tracking Stock Equity Structure: The Need for a Duty of Fairness, 94 Mich. L. Rev. 2089, 2096-97 (1996).

<sup>109</sup> For example, a party could use single-stock futures to purchase a controlling voting stake in a corporation with actually paying to purchase stock; legal rules have not evolved to prohibit this practice.

<sup>110</sup> Arguably, both quorum rules and percentage-based rules of securities law (e.g., the “ten percent” insider holding rule under Section 16(b)) should be adjusted upward to reflect the disparity between the number of record shares issued by the corporation and the number of shares broker permit to vote (or, alternatively, the rules should be adjusted to deprive encumbered shares of votes). If these rules are not adjusted upward, the existence of encumbered shares will lead to more corporations satisfying their quorum requirements than should, and to more shareholders falling within percentage categories of securities law than should, both inefficient results (assuming the validity of current rules). Put another way, encumbered shares make it easier for corporations to satisfy quorum rules than is intended by state law, and bring more shareholders within the coverage of securities regulation than is intended by federal law. Neither is an efficient result.

pure residual shareholders. The assumption that arbitrageurs and other shareholders share the same incentives permits arbitrageurs to profit by encouraging or advancing suboptimal economic arrangements that destroy the value of shares.

Voting arbitrage can occur in many ways. For example, arbitrageurs whose pure shareholdings are outweighed by other portfolio positions have incentives to elect directors who will not maximize share value (e.g., by increasing volatility, to the benefit of option holders but to the detriment of unencumbered shareholders; by taking on projects with negative net present value; or by not taking on projects with positive net present value). Similarly, encumbered shareholders have incentives to advance or vote for suboptimal shareholder proposals (or to refrain from voting for shareholder proposals that would maximize share value).<sup>111</sup> Encumbered shareholders also have incentives to approve compensation schemes that reduce shareholder value, in particular, to create managerial incentives that are more consistent with their own distorted incentives than those of pure residual shareholders.<sup>112</sup>

Perhaps most importantly, encumbered shares substantially distort the market for corporate control.<sup>113</sup> Encumbered shareholders will not favor mergers that would benefit pure residual shareholders; instead, they might instead favor mergers that would destroy share value. For example, a shareholder who owns ten shares but is short one hundred shares (or long one hundred puts) would vote for any merger that would reduce the value of her shares, including a below-market tender offer. Similarly, such a shareholder would advocate implementing takeover defenses, even if such defenses would reduce share value. The inefficiency of such a result is obvious.

The distortion generated by encumbered shares is not merely theoretical; it substantially affects prevailing market practices, especially in large public company mergers and acquisitions of greatest interest to scholars. Particularly in share exchange mergers, arbitrageurs buy millions of shares of the target corporation and sell short shares of the acquirer corporation (a practice known as “risk arbitrage”) to capture price disparities between merger-related shares. As a result, millions of target shares – a substantial percentage of the outstanding shares – come to be owned by encumbered shareholders with a single incentive: to ensure that the deal is approved, regardless of its merits. If the deal is approved, the risk arbitrageur’s long and short positions offset, leaving an arbitrage profit. The only way such encumbered shareholders lose money is if the deal fails. Accordingly, the one-share/one-vote rule, which gives a vote to

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<sup>111</sup> In addition, millions of shares are held by program traders who do not have the economic incentive to increase share value (because they simultaneously hold shares and countervailing negative equity positions) and therefore will have no reason to oppose initiatives that benefit managers but not shareholders.

<sup>112</sup> Some scholars have argued that options compensation is necessary to overcome managerial risk aversion. However, if shareholders are encumbered by call options holdings, they will have an incentive to award managers call options even if managers are not risk averse (or to over-reward options so that managers become risk-preferring). A similar analysis applies to other options positions.

<sup>113</sup> The literature on the market for corporate control, including the abundant scholarship related to takeover defenses, has not taken into account this phenomenon.

arbitrageurs regardless of their economic incentives, will lead to mergers being approved even if they do not benefit pure residual shareholders.<sup>114</sup>

In addition to suboptimal merger approval, voting by encumbered shares also results in inefficient choice of merger form. In particular, encumbered shares will favor fixed ratio share exchanges rather than cash or variable ratio share exchanges, even if a fixed ratio share exchange would generate less share value. Risk arbitrage is substantially easier, and more profitable, in fixed-ratio share exchanges.<sup>115</sup> Because increased holdings by encumbered arbitrageurs make approval by target shareholders more likely, acquirers will have an inefficient voting-related preference for fixed ratio exchanges, regardless of whether this form in fact maximizes share value.<sup>116</sup>

### B. *Litigation Arbitrage*

Recall that Easterbrook and Fischel defend the prevailing one-share/one-vote rule as efficient because every shareholder has a claim on the residual assets of the firm. In modern financial markets, however, this is not the case,<sup>117</sup> particularly when those residual assets actually are distributed, as in shareholder class actions or in corporate bankruptcy.<sup>118</sup> Indeed, in these instances, adhering to the fiction that each shareholder is entitled to a like residual interest causes substantial inefficiencies, and simultaneously overcompensates the encumbered shareholder and undercompensates the pure residual shareholder. The prospect of overcompensation creates incentives for parties to engage in inefficient “litigation arbitrage,” transacting to obtain the legal rights associated with class action or bankruptcy proceedings.

For example, in a shareholder class action, distributions (either in a settlement or judgment) are made to any shareholder who can demonstrate ownership of the stock during the class period. This includes encumbered shares. The settlement and judgment amount is based upon the number of record shares outstanding during the class period; however, due to legal encumbrances (i.e., lending and shorting), the actual number of shares is greater than this number. Moreover, economically encumbered shareholders are entitled to recover, even if they were not damaged (or even if, as a result of their net

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<sup>114</sup> “Reverse arbitrage” – buying acquirer shares, shorting target shares, and voting against the merger – potentially could offset such behavior, but the limited liquidity of typically smaller targets generally precludes such an approach.

<sup>115</sup> In a cash deal, shorting the acquirer makes no sense; in a variable ratio share exchange, the risk arbitrageur does not know how many acquirer shares to short and is therefore exposed to additional risk.

<sup>116</sup> Of course, parties might choose a merger form for other reasons (e.g., tax or accounting), but to the extent arbitrage occurs, it will result in parties favoring a fixed share exchange more than they should.

<sup>117</sup> The claim of homogeneity is easier to make with respect to dividend payments, because all shareholders, regardless of whether they are legally encumbered, are entitled to payment of dividends, either from the corporation or from a short seller. However, just as short sellers are not obligated to deliver votes to share purchasers, short sellers are not obligated to make additional payments as a result of distributions in class action lawsuits or bankruptcy.

<sup>118</sup> See John C. Coffee, Jr., Rethinking the Class Action: A Policy Primer on Reform, 62 Ind. L.J. 625 (1987).

negative equity position, they profited).<sup>119</sup> Because encumbered shares are entitled to recover pro rata, unencumbered shares receive less than the compensation necessary to make them whole, and encumbered shares receive a windfall.

Similarly, shareholders hold residual claims to the assets of a corporation in bankruptcy.<sup>120</sup> Although shareholders typically recover only a small interest in bankruptcy, that recovery assumes that each shareholder receives a pro rata share, even though there are more shareholders seeking such claims in bankruptcy than the number of outstanding shares. As a result, in bankruptcy, the distribution of shareholder rights is especially confused.

Contrast bankruptcy rights with the rights to dividends or a vote. With respect to dividends, the original shareholder retains the right to payment, and the purchaser of the loaned shares from a short seller receives payment of dividends from the shorting party. With respect to voting, the original shareholder believes she retains the right to a vote, but technically the purchaser of the loaned shares from the shorting party acquires the voting right. With respect to bankruptcy, the transfer of rights is indeterminate: both the original shareholder and the purchaser of loaned shares believe they are entitled to residual rights, but one of them must be wrong.

With respect to voting, brokers have created elaborate mechanisms to ensure that both shareholders can vote. With respect to bankruptcy, it is not possible to manufacture additional residual interests. Accordingly, overclaims can be avoided only if the number of shares loaned and shorted is less than the number of shares that do not appear to claim a residual interest. Moreover, even if overclaiming does not occur, the fact that a single share is generating multiple claimants to a single residual share interest results in both overcompensation with respect to that particular share and undercompensation with respect to the other “pure” shareholders. The same is true for any corporate dissolution or windup.

In general, it is far too simplistic to assume that shareholders uniformly hold the residual claims to a corporation’s assets or cash flows. Indeed, in litigation where such residual claims are actually executed, the one-share/one-vote approach is unfair and inefficient. In both class action lawsuits and bankruptcy litigation, the assumption that all common shareholders have “similar if not identical” preferences and homogeneous claims leads to perverse results. Scholars (and legal rules) should recognize what is apparent from financial innovation: not every share should not be entitled to a vote.

## VI. CONCLUSION

Because of financial innovation, many shares are encumbered, economically or legally. Shareholders do not uniformly have appropriate incentives to make discretionary decisions. Shareholders do not always have a residual claim to a corporation’s income or

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<sup>119</sup> For example, a holder of a one share long position and a ten share short position would be entitled to recover a share of the proceeds of the settlement or judgment based on the one share position, even though her actual economic position was a profit of nine times the losses associated with one share.

<sup>120</sup> In addition, to the extent bondholders replace shareholders in the capital structure – and obtain votes (or are owed fiduciary duties) – the same analysis of encumbrances applies, this time to encumbered bondholders.

assets. Shareholders are not the only parties who receive the margin gains (and incur the marginal costs) of corporate decisions; indeed, encumbered shareholders might be indifferent or hostile to gains (and instead embrace losses).

The corporate law literature has argued that one-share/one-vote is, and should be, the dominant rule and practice. We have shown that this argument is based on assumptions that do not hold. Given the proliferation of financial innovation and economic and legal encumbrances, the one-share/one-vote principle no longer constitutes an efficient rule of corporate governance, if it ever did.