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The False Promise of One Share, One Vote

Grant M. Hayden

Southern Methodist University - Dedman School of Law

Matthew T. Bodie

Saint Louis University School of Law

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THE FALSE PROMISE OF ONE SHARE, ONE VOTE

Grant M. Hayden^{*}
Matthew T. Bodie^{**}

^{*} Professor, Hofstra University School of Law. J.D. Stanford Law School.

^{**} Associate Professor, Saint Louis University School of Law. J.D. Harvard Law School. We thank Julian Ku and Ron Colombo for their insightful comments on earlier versions of this article.

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INTRODUCTION

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

However, a convergence of economic, demographic, and legal forces has created the new world of “shareholder democracy.” The growth of institutional shareholders has been accompanied by their interest in exercising collective power to oversee management. As part of their oversight, these shareholders are taking their voting rights seriously. Difficulties in exercising this power still remain, and shareholder democracy advocates have an array of proposals designed to make their voting rights more effective.² But as one set of commentators has noted, “Never has voting been more important in corporate law.”³

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

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

³ Marcel Kahan & Edward B. Rock, *The Hanging Chads of Corporate Voting*, Working Paper, August 2007, available at: <http://ssrn.com/abstract=1007065>.

The new importance vested in corporate democratic processes has raised the stakes for the construction of the polity. Lopsided voting arrangements that give a small minority disproportionate power have come under increasing scrutiny.⁴ Just as “one person, one vote” resonates with fairness for the average American, the phrase “one share, one vote” provides a powerful slogan for shareholder governance in our corporate law. The phrase is appealing because it provides a system of governance based on a reductive but equitable distribution: each unit shall have the same power of control over the organization. “One share, one vote” has been described as “the most basic statutory rule of [corporate] voting”⁵ as well as consistent with “democratic intuition and liberal tradition.”⁶ Although the standard is simply a default rule in most jurisdictions, most publicly traded companies have adopted it, and it remains the presumptive norm.⁷

Corporate law scholars generally accept the “one share, one vote” standard as the basis for efficient distribution of the

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

⁵ FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 72 (1991).

⁶ Caroline Fohlin, *The History of Corporate Ownership and Control in Germany*, in *A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS* 223, 262 (Randall K. Morck ed., 2005), quoted in Colleen Dunlavy, *Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights*, 63 WASH. & LEE L. REV. 1347, (2006).

⁷ ROBERT C. CLARK, *CORPORATE LAW* 361 (1986). The standard has been increasingly popular in European states. Guido Ferrarini, *One Share – One Vote: A European Rule?*, § III.2.3, ECGI Law Working Paper No. 58/2006, Jan. 2006, available at: <http://ssrn.com/abstract=878664> (“[T]he law and practice in European countries is slowly converging toward Anglo-American corporate governance standards, including one share – one vote.”). And European Union officials have pushed corporations toward “one share, one vote” in order to “eliminate discriminatory treatment of shareholders.” Tobias Buck, *EU Seeks to End Bias Among Investors – Commission Wants ‘One Share, One Vote’ Principle*, FIN. TIMES (London 8th ed.), Oct. 17, 2005, at 1 (quoting EU internal market commissioner Charlie McCreevy).

corporation's voting rights.⁸ According to the theory, shareholders have the right to control the corporation because they own the rights to the residual interest in the corporation (i.e., its profits). Because all other stakeholders in the corporation – employees, suppliers, customers – are entitled to their contractual claims before profits are paid, shareholders are in the best position to maximize the overall wealth generated by the corporation.⁹ The notion that shareholder interests should be pursued as the ultimate ends of the corporation is known as shareholder primacy theory, or the shareholder wealth maximization norm. The shareholder franchise is one way of ensuring that the corporation pursues these ends. Moreover, the “one share, one vote” standard is the best way of ensuring that these ends are pursued. Each shareholder should have one vote for each share so that all shareholders have voting power equivalent to their interest in the residual. This provides all shareholders with the proper incentives to oversee management, choose to accept or reject a proposed merger, and otherwise maximize the wealth generated by the corporation. Otherwise, shareholders would have disproportionate interests in the residual, resulting in disproportionate voting interests.

Critical to the success of this theory, however, is the notion that all shareholders have the same interest – namely, maximizing the residual value of the corporation. Shareholder primacy theory maintains that all shareholders have homogeneity of interest; indeed, it is seen as a necessary aspect of the theory. If the purpose of the corporation is to maximize the residual, then the shareholders must all agree with this purpose. Otherwise, shareholders may elect directors who will pursue interests apart from residual wealth maximization. Thus, corporate law theorists have repeatedly emphasized the homogeneity of shareholder interests as a critical assumption of the model.¹⁰

⁸ Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 777 (2005) (“[S]cholars have not seriously challenged the theoretical underpinnings of the dominant one-share/one-vote approach to corporate voting.”);

⁹ EASTERBROOK & FISCHER, *supra* note EF1, at **.

¹⁰ Paul H. Edelman & Randall S. Thomas, *Corporate Voting and the Takeover Debate*, 58 VAND. L. REV. 453, 464 (2005) (discussing the assumption of homogeneity in other corporate law models).

Recent developments in the field of finance, however, have called shareholder homogeneity into question. For example, new derivative financial products allow stockholders to hedge their financial interest such that they no longer have the same interests as their shareholding counterparts.¹¹ As a result, hedged shareholders might vote against the interests of the corporation in order to maximize the value of their derivative stake. Conversely, shareholders may retain “hidden” ownership of their shares, such that immense voting power in the corporation can be pulled out from seeming thin air when this voting power would be instrumental.¹² Such shareholders have greater voting power than their reported stock ownership all would indicate; indeed, their voting power may be much greater than their interest in residual profits. Based on these conflicts between shareholder interests, some scholars have argued that the theory behind “one share, one vote” is no longer valid and have pushed to exclude certain shareholders from the franchise.¹³

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

Moreover, even if shareholders were homogenous, their single-minded focus on profits would not justify giving them sole control over the corporation. Easterbrook and Fischel, in their

¹¹ See, e.g., *id.* at 778 (describing how equity derivatives may allow a shareholder to reallocate their interest in the residual); Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 815 (2006) (noting that “[i]n an extreme case, an investor can vote despite having negative economic ownership”).

¹² Hu & Black, *supra* note HB1, at 836-42.

¹³ Martin & Partnoy, *supra* note MP1, at 778, 793.

classic article (and later, book) on shareholder voting, justified the shareholder franchise as the best way to aggregate preferences along a certain axis without descending into constant struggles over power.¹⁴ However, their analysis misreads the literature on social choice and preference aggregation. The need for agreement along a single spectrum fails to justify the elevation of shareholder preferences above all others. When we remove the assumption of shareholder homogeneity and consider the actual conflicted nature of their preferences, we can no longer justify shareholder democracy based on the traditional rationales.

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

I. VOTING IN THE POLITICAL ARENA

A. The Basic Structure of Voting Rights Law

Life is full of decisions. Some are fairly simple, like what one should order for dinner. A preference for one dish over the

¹⁴ Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983); EASTERBROOK & FISCHEL, *supra* note EF1, at **.

others drives the decision. Decisions made by groups of people, though, are more complicated. When forced to order a dish for a group, we need some way of moving from individual desires to a group decision.¹⁵ We need, in other words, a social choice function.¹⁶ There are many kinds of social choice functions to choose from—we could just order what one person wants (the dinner dictator), we could flip a coin, or we could use an approach that seems to better capture the preferences of the members of the group, such as voting. Most democratic institutions have taken this third approach when it comes to translating individual preferences into group choices.¹⁷ Indeed, voting is the sine qua non of democratic decision-making.

When political institutions settle on voting as the preferred method of preference aggregation, they still have many decisions to make about how to structure the process. Those decisions often come to be embodied in a set of legal entitlements, or voting rights, which collectively sketch the contours of polity. These voting rights, though, are not unidimensional; instead, there are at least three distinct facets to the rights to vote, each of which is necessary to ensuring full democratic participation.¹⁸

¹⁵ The study of how we make such moves comes under the heading of social choice theory, which has entered the legal literature under the guise of public choice theory. *See, e.g.*, MAXWELL L. STEARNS, PUBLIC CHOICE AND PUBLIC LAW: READINGS AND COMMENTARY (1997); DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION (1991).

¹⁶ The terminology here follows WILLIAM H. RIKER, LIBERALISM AGAINST POPULIST: A CONFRONTATION BETWEEN THE THEORY OF DEMOCRACY AND THE THEORY OF SOCIAL CHOICE (1982). A social choice function is a rule that translates a preference profile (a set of individual preference orders, one for each member of society) into a social preference order (a complete arrangement of alternatives in order of their attractiveness to society as a whole). *Id.* at 18, 296-97.

¹⁷ *See* NORMAN FROHLICH & JOE A. OPPENHEIMER, MODERN POLITICAL ECONOMY 16 (1978).

¹⁸ This taxonomy is borrowed from Pamela S. Karlan, *Maps and Misreadings: The Role of Geographic Compactness in Racial Vote Dilution Litigation*, 24 HARV. C.R.-C.L. L. REV. 173, 176 (1989). *See also* Grant M. Hayden, *Resolving the Dilemma of Minority Representation*, 92 CALIF. L. REV. 1589, 1594-1602 (2004) (giving a brief account of the history of each aspect of the right). Other ways of parsing out the right to vote, *see, e.g.*, Richard H. Pildes, *What Kind of Right is "The Right to Vote"?*, 93 VA. L. REV. 43 (2007); Pamela

The first aspect of the right involves access—the ability to cast a ballot.¹⁹ This is voting rights at its most fundamental, and is what people are usually talking about when discussing the right to vote. But the mere ability to cast a ballot is not sufficient to ensure meaningful participation. One's vote must be accorded sufficient weight and must be combined with those of other like-minded voters to give the voter an opportunity to influence the outcome of an election. Hence the development of the second and third aspects of the right to vote. The second aspect is the right to cast a vote that carries an appropriate numerical weight, one that is quantitatively undiluted.²⁰ For most elections in the United States, this means that the election districts must be drawn in ways consistent with the principle of one person, one vote. Even with equal access and equal weighting, however, voters may be denied meaningful participation though a variety of other political

S.Karlan, *The Rights to Vote: Some Pessimism About Formalism*, 71 TEX. L. REV. 1705, 1709-20 (1993), are not inconsistent with this conception.

¹⁹ For a relatively recent history of the right to vote, see ALEXANDER KEYSSAR, *THE RIGHT TO VOTE: THE CONTESTED HISTORY OF DEMOCRACY IN THE UNITED STATES* (2000). For information about voting in the early years of the republic, see MARCHETTE G. CHUTE, *THE FIRST LIBERTY: A HISTORY OF THE RIGHT TO VOTE IN AMERICA, 1619-1850* (1969); CHILTON WILLIAMSON, *AMERICAN SUFFRAGE: FROM PROPERTY TO DEMOCRACY, 1760-1860* (1960). For information about voting rights in more recent years, with an emphasis on the quest for minority representation, see *QUIET REVOLUTION IN THE SOUTH: THE IMPACT OF THE VOTING RIGHTS ACT, 1965-1990* (Chandler Davidson & Bernard Grofman eds. 1994); BERNARD GROFMAN, LISA HANDLEY & RICHARD NIEMI, *MINORITY REPRESENTATION AND THE QUEST FOR VOTING EQUALITY* (1992); STEVEN F. LAWSON, *BLACK BALLOTS: VOTING RIGHTS IN THE SOUTH, 1944-1969* (1976); J. MORGAN KOUSSER, *THE SHAPING OF SOUTHERN POLITICS: SUFFRAGE RESTRICTION AND THE ESTABLISHMENT OF THE ONE-PARTY SOUTH, 1880-1910* (1974).

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

practices such as gerrymandering and at-large districting.²¹ Such practices, which may qualitatively dilute a group's voting power, gave rise to the third aspect of the right to vote, and are at the heart of much of the nation's voting rights litigation today. A robust understanding of the right to vote, then, involves several distinct (yet related) components. Full democratic participation depends upon enforcement of all three aspects of the right.

B. Theoretical Underpinnings of the Right to Vote

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

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

²¹ See Hayden, *supra* note XX, at 1600-02 (detailing minority vote dilution); Samuel Issacharoff, *Gerrymandering and Political Cartels*, 116 HARV. L. REV. 593 (2002) (discussing political gerrymandering).

1. Voting Rights and Interest

a. Interest and Access

Debates regarding the most basic issue in voting rights—who should be allowed to vote—are informed by many things. But chief among these is an assessment about the degree to which a potential voter is affected by the outcome of the election.²² Those with a strong interest in the outcome, with a sufficient stake, are prime candidates for the franchise. Those with little or nothing riding on the outcome, on the other hand, are rarely extended voting rights. Figuring out which people have a sufficient stake in the outcome of an election, and hence a right to vote, is contentious. But there is an often an underlying point of agreement—that we can make that decision based, in large part, on the relative strength of one’s interest in the election.

This should not come as a great surprise. Voting, after all, is a social choice mechanism, a way of moving from individual preferences over an array of alternatives (candidates, propositions, dinner options) to group choices. And this is done in a way intended to maximize preference satisfaction.²³ People with a strong interest in the outcome of a vote, with correspondingly strong preferences, are obviously the first candidates for the right to vote in such an election. People with weak or nonexistent preferences with respect to the outcome of a vote do not have much to contribute to this end—their lives, their interests, their happiness, are not much affected by the outcome.

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

²³ Hayden, *supra* note XX, at 248-49.

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

There is, unfortunately, no way to directly test the strength of people’s preferences in order to see who should vote. We could, for example, just ask people how strong their interests are, but there would be numerous problems with that approach. First, while many individuals may accurately report that they feel more or less strongly about the outcome of any election, there is no way for them (or anyone else) to neutrally compare those reports with those of other individuals.²⁴ There is no universal scale upon which to measure everyone’s preference strength and, even if there were, there is no omniscient social scientist to peer directly into everyone’s minds and make a proper assessment.²⁵ Second, making those kinds of person-by-person assessments by polling or interviewing people would be prohibitively expensive, especially when you consider the fact that all representative governments would need to assess all potential voters.²⁶ And, finally, we would be worried about strategic misrepresentation of the strength of one’s preferences, especially since something useful (voting rights) would come with the expression of a strong interest in the outcome

²⁴This is generally discussed as the difficulty in making interpersonal comparisons of utility. For a summary of the problem, see Hayden, *supra* note XX, at 236-47. See also INTERPERSONAL COMPARISONS OF WELL-BEING (Jon Elster & John E. Roemer eds., 1991); James Griffin, WELL-BEING: ITS MEANING, MEASUREMENT, AND MORAL IMPORTANCE 113-20 (1986); Peter Hammond, *Interpersonal Comparisons of Utility: Why and How They Are and Should Be Made*, in INTERPERSONAL COMPARISONS OF WELL-BEING 200, 238-254 (Jon Elster & John E. Roemer eds., 1991).

²⁵ See Hayden, *supra* note XX, at 245.

²⁶ You could not rely on some other proxy for strength of voter interest, such as residency, for that would beg the question.

of an election.²⁷ Relying on first-person reports, then, would not work, and has not been the way governmental entities have made such assessments.²⁸ They have instead relied on various proxies for one's level of interest in the outcome of an election.

There are both historical and contemporary examples involving debates over the extent of the franchise that make this point clear. Many states at the turn on the nineteenth century limited voting to white men who owned a certain amount of real property. These freehold requirements were supported by the idea that those who possessed such property “had a unique ‘stake in society’ – meaning that they were committed members of (or shareholders in) the community and that they had a personal interest in the policies of the state, especially taxation.”²⁹ The taxpaying requirements that replaced freehold requirements in the early nineteenth century were justified on similar grounds—that only those who shoulder the burdens of government should have a voice in it (turning the traditional rallying cry on its head: “No representation without taxation”).³⁰ In both instances, economic participation is seen as a proxy for an interest in the outcome of an election, and thus a proper prerequisite to the right to vote.

Modern restrictions on the franchise are often justified on the same grounds. Take, for example, residency requirements. Residency requirements are ubiquitous, and such an entrenched part of the democratic landscape that they are rarely analyzed as mechanisms that disenfranchise enormous numbers of people. They go largely unquestioned because we think that residency usually serves as an accurate proxy for one's interest in the outcome of an election. The scope of most government entities' powers is geographically circumscribed, and the belief is that only those living within the territory under control of the entity have enough at stake to vote.³¹ In those rare situations when academics or courts challenge residency requirements, they challenge this link

²⁷ See Hayden, *supra* note XX, at 240.

²⁸ Except to the extent that voting is not compulsory in the United States. Qualified voters could always just signal their lack of interest by staying home on election day. See Hayden, *supra* note XX, at 258-59.

²⁹ KEYSSAR, *supra* note XX, at 5.

³⁰ See *id.* at 50, 131.

³¹ See Hayden, *supra* note XX, at 256-57; Smith, *supra* note XX, at 1159.

between residency and interest, arguing that residency, or the lack of it, is not an accurate proxy for the strength of one's interest in the outcome of the elections.³² Instead there are certain classes of nonresidents—such as people who work in the jurisdiction, people who own property in the jurisdiction, or people otherwise affected by the entity's actions—that may be sufficiently affected by the decisions of the governmental entity to be entitled to vote.³³ But the underlying assumption—that only people with a certain degree of interest in the outcome of an election should be allowed to vote—is shared by all.

The Supreme Court has repeatedly endorsed the relationship between the right to vote and the degree of interest in an election. They were most explicit about it in *Kramer v. Union Free School District*, a case involving a challenge to a New York statute that limited voting in school board elections to people who either (1) owned or leased taxable real property in the district, or (2) had children enrolled in the district's schools.³⁴ The statute was challenged by a childless man who lived with his parents in the district.³⁵ The Court struck down the restrictions on the franchise as both over- and underinclusive:

[A]ppellant resides with his parents in the school district, pays state and federal taxes and is interested in and affected by school board decisions; however, he

³² See *Holt Civic Club v. City of Tuscaloosa*, 439 U.S. 60, 69 (1978) (explaining that “the imaginary line defining a city’s corporate limits cannot corral the influence of municipal actions. A city’s decisions inescapably affect individuals living immediately outside its borders.”); Richard Briffault, *The Local Government Boundary Problem in Metropolitan Areas*, 48 STAN. L. REV. 1115, 1132 (“Boundaries exclude people who may be interested in or affected by the decisions made within the boundaries.”).

³³ See Hayden, *supra* note XX, at 257. For this reason and others, some scholars have suggested decoupling voting from residency. See Richard Thompson Ford, *Beyond Borders: A Partial Response to Richard Briffault*, 48 STAN. L. REV. 1173, 1187-89 (1996); Richard Thompson Ford, *The Boundaries of Race: Political Geography in Legal Analysis*, 107 HARV. L. REV. 1841, 1909 (1994); Jerry Frug, *Decentering Decentralization*, 60 U. CHI. L. REV. 253, 324-25 (1993). For a critique, see Briffault, *supra*, at 1158-62.

³⁴ 395 U.S. 621, 622 (1969).

³⁵ *Id.* at XXX.

has no vote. On the other hand, an uninterested unemployed young man who pays no state or federal taxes, but who rents an apartment in the district, can participate in the election.³⁶

The restrictions were problematic to the extent that they didn't correspond well enough to one's interest in the outcome of the election. The underlying assumption was made explicit by the Court when it explained that a state could indeed limit the franchise to a portion of the electorate that was "primarily affected" by the outcome: it just needed to demonstrate that "all those excluded are in fact substantially less interested or affected than those the [franchise] includes."³⁷ But the state's goal—to connect the right to vote with the strength of one's interest in the election—was proper.

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

b. Interest and Weighting Votes

There may be a similar sort of agreement with respect to assigning numerical weights to votes.³⁸ After all, the strength of people's preferences vary widely. At some point, we may decide that their interests are strong enough that they should have the right

³⁶ *Id.* at 632 n.15.

³⁷ *Id.* at 632.

³⁸ One would expect these two aspects of voting rights to be closely related since numerically diluting a vote may have the same effect as prohibiting voting. *See* Hayden, *supra* note XX, at 255.

to vote. But that simple, binary approach to voting rights (either you have the vote or you don't) doesn't fully capture the range of people's interests. Perhaps the weight of each person's vote should be calibrated to the strength of their interest in the outcome. Everyone person's vote could be assigned a relative weight that reflects the strength of their preferences—thus providing some optimal level of participation.³⁹

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

At first glance, the answer appears to be no. The one-person, one vote standard, which assigns everyone's vote about the same weight, dominates the political landscape. This could mean several things (in addition to the fact that we're just wrong and something else drives these decisions). It may reflect a positive judgment that everyone has, more or less, about the same level of interest in the outcome of most political elections.⁴⁰ But that just doesn't make sense: we know that people have a wide range of levels of interest, at least wider than is captured by a simple decision whether or not to allow them to place an equally-weighted vote. Another possibility is that there may be something else at work here, something that limits our ability to develop a more nuanced vote-weighting system. And given what was discussed above, about the difficulties in making interpersonal utility comparisons, this appears to make more sense.

As opposed to a positive judgment about the equal-strength of voter preferences, the Supreme Court's one person, one vote standard may actually involve a negative judgment that we will rarely have the type of information about preference strength to assign more nuanced weight to votes.⁴¹ It's our inability to

³⁹ See *id.* at 248.

⁴⁰ See *id.* at 251.

⁴¹ See *id.* at 251-52.

objectively compare relative preference strength that drives our reliance on the one person, one vote standard. Of course, a requirement that political institutions assign equal weight to votes, just like a requirement about assigning differing weights to votes, is itself a judgment about the relative strength of preferences that cannot be grounded on neutral principles.⁴² But this may just mean that the Supreme Court was fooling itself when it thought it was developing a neutral, judicially manageable standard for quantitative vote dilution (something that the dissenters to the original malapportionment cases rightly argued at the time).⁴³

This view is also confirmed, oddly enough, by an exception to the one person, one vote requirement. As outlined above, the equiproportional standard applies to Congressional and state legislative districts. And it applies to local governmental units that exercise general governmental powers—those that might be expected to affect everyone within the jurisdiction in a similar manner, or to a similar degree.⁴⁴ But what about local units that disproportionately affect identifiable groups? The Supreme Court first raised that question in *Avery v. Midland County*, where it noted:

Were the Commissioners Court a special-purpose unit of government assigned the performance of functions affecting definable groups of constituents more than other constituents, we would have to confront the question whether such a body may be apportioned in ways which give greater influence to the citizens most affected by the organization's functions.⁴⁵

⁴² See *id.* at 249-50.

⁴³ See *id.* at 250; *Baker v. Carr*, 369 U.S. 186, 300 (1962) (Frankfurter, J., dissenting) (arguing that a equiproportional standard is just one among many “competing bases of representation.”).

⁴⁴ See *Morris v. Board of Estimate*, 489 U.S. 688, 694-96 (1989); *Hadley v. Junior College Dist.*, 397 U.S. 50, 54 (1970); *Avery v. Midland County*, 390 U.S. 474, 484-85 (1968);; *Hayden*, *supra* note XX, at 252-53.

⁴⁵ *Avery*, 390 U.S. at 483-84.

The Supreme Court was forced to confront this issue of special purpose districts just a few years later in *Salyer Land Co. v. Tulare Lake Basin Water Storage District*.⁴⁶

Salyer involved a sparsely populated water district that covered close to 200,000 acres of farmland.⁴⁷ The district, governed by an elected board of directors, was in charge of the acquisition, storage, and distribution of water.⁴⁸ Participation in the board elections, however, was limited to landowners, and their votes were apportioned based on the assessed valuation of the land they owned (a one acre, one vote system).⁴⁹ This was challenged as a violation of the one person, one vote requirement, but the Supreme Court rejected the challenge and, in so doing, created the special purpose district exception to the requirement.⁵⁰ The Court found that, in cases like this, such a system made sense because the board's powers disproportionately affected landowners (as opposed to mere residents), and affected them in proportion to the amount of land they owned.⁵¹

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

⁴⁶ 410 U.S. 719 (1973).

⁴⁷ *See id.* at 723.

⁴⁸ *See id.*

⁴⁹ *See id.* at 724-25.

⁵⁰ *See id.* at 730.

⁵¹ *See id.* at 729, 734.

c. Interest and Combining Votes

Once we ensure that those with sufficiently strong preferences with respect to the outcome of an election have the vote, and we've calibrated those votes, if possible, to the degree of preference strength, there remains work to be done. It turns out that there are many ways to prevent groups of voters from successfully aggregating their preferences. The third facet of voting rights—the right to a qualitatively undiluted vote—is designed to prevent this from happening. So does the concern with preference strength inform this third facet of voting rights as well?

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

Second, the benchmark for claims of qualitative vote dilution seems to involve some assessment of proportionality. Every election has its winners and losers—that's how democracy works. The difficulty in assessing claims of qualitative vote dilution is separating out victims from mere losers. How do we tell for the purposes of section 2 of the Voting Rights Act, for example, when a minority group has had less opportunity to participate and elect representative of its choice? What is the standard for assessing dilution? While there is no simple answer to the question, almost

all solutions depend, in part, on an assessment of proportionality.⁵² Proportionality is not strictly applied in most instances, and there is even an express prohibition against a guarantee of proportionality in section 2 of the Voting Rights Act.⁵³ Yet it is difficult to conceive of a qualitative vote dilution standard completely detached from it.

The structure of voting rights in the political arena, then, involves a series of decisions about how to best aggregate individual preferences into group choices. Generally, we allow those with sufficiently strong interests with respect to the outcome to vote. In cases where we have more nuanced information about the strength of that interest, we allow entities to calibrate the numerical weight assigned to those votes. And in aggregating votes, we worry about various devices that may thwart the collective expression of these preferences. Many of a polity's decisions with respect to voting rights, then, depend upon finding successful proxies for the strength of voter interest in the outcome of an election.

2. Proxies for Voter Interest

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

⁵² See Sanford Levinson, *Gerrymandering and the Borrding Omnipresence of Proportional Representation: Why Won't It Go Away?*, 33 U.C.L.A. L. REV. 257 (1985).

⁵³ See 42 U.S.C. § 1973 (2006) (“[N]othing in this section establishes a right to have members of a protected class elected in numbers equal to their proportion in the population.”).

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

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

Take, for example, some of the proxies that have been used in the United States for voter interest. The early property-holding requirements were fine as far as they went, but they were underinclusive, disenfranchising vast numbers of property-less residents who had vital interests in the exercise of governmental powers. Residency requirements, on the other hand, seem to better capture the group of interested people, since most people within the geographic jurisdiction of a governmental entity—and thus subject to its police powers, taxing powers, etc.—have quite a bit at stake in the outcome of an election. Residency, of course, may be underinclusive in that it fails to capture nonresidents who work,

own property, or have other interests in the jurisdiction (or overinclusive since it may enfranchise people who are moving out of the jurisdiction the day after the election and thus have little at stake), but not nearly so much as property-holding requirements. And, as discussed above, states are often prohibited from using a proxy that is too underinclusive, too overinclusive, or both. New York's attempt to use having children in the school system or owning or renting taxable real estate as a proxy for interest in the outcome of school district elections, for example, was struck down as both underinclusive and overinclusive.

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

The manageability of a proxy may mean several things,⁵⁴ but, for our purposes, we merely mean whether it is realistically workable. There are many reasons why proxies might be unmanageable. They may be physically impossible (using brain scans to compare preference strengths). They may be too costly (using extensive, constantly updated surveys). Or they may be too readily manipulated (relying on a potential voters' professed interest in an election). In other words, something—be it cost, fraud, or some other factor—may prevent the proxy from accurately reflecting the preference strength of people its designed to test.

⁵⁴ In voting rights, the manageability of a particular voting rights requirement might mean, for example, that courts will be able to administer the standard in a neutral manner, without injecting its own biases into the case.

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

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

The difficulty in finding manageable proxies for more subtle assessments of preference strength may explain why equal weighting is often the default rule in democratic elections.⁵⁵ The one person, one vote standard, for example, is nothing if not easily manageable: one just needs to be able to count and divide.⁵⁶ Like some of the easily administered proxies for basic interest in an election, however, there may be reasons why the equal weighting of votes doesn't come close to accurately capturing preference strength. As John Hart Ely noted, the one person, one vote

⁵⁵ See Hayden, *supra* note XX, at XX.

⁵⁶ Avery v. Midland County, 390 U.S. 474, 510 (1968) (Stewart, J., dissenting) (maintaining that apportionment is "far too subtle and complicated a business to be resolved as a matter of constitutional law in terms of sixth-grade arithmetic").

standard “is certainly administratable. . . , the more troublesome question is what else it has to recommend it.”⁵⁷

* * *

There is a great deal of underlying agreement, then, that the right to vote, and the weight assigned to that vote, should correspond to the level of a voter’s interest in the outcome of the election. Perfect correspondence between voting rights and interest, though, is unattainable, because we do not have precise methods for assessing the strength of voter preferences with respect to any particular election. We must therefore rely upon various proxies that imperfectly capture the degree of voter interest, and strike a balance between the accuracy and manageability of a proxy. In this way, a democratic polity is designed to best reflect the interests of those affected by the exercise of its powers.

II. VOTING IN THE CORPORATE ARENA

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

One share, one vote, however, is not the “timeless and natural” voting structure that it appears.⁵⁸ It is neither a

⁵⁷ JOHN HART ELY, *DEMOCRACY AND DISTRUST* 121 (1980).

⁵⁸ Dunlavy, *supra* note CD1, at 1356 (discussing this perception).

requirement here in the United States nor in Europe,⁵⁹ and in fact the percentage of companies with alternative voting structures is increasing.⁶⁰ Moreover, shareholder voting has gone through a number of historical trends, reflecting the economical and political concerns of different eras. Indeed, other forms of business organizations aggregate the preferences of their members in quite different fashion.

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

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

⁵⁹ *Id.* at 1349.

⁶⁰ Marco Brecht & J. Bradford DeLong, *Why Has There Been So Little Block Holding in America?*, in *A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS* 613, 653-57 (Randall K. Morck ed., 2005) (noting that the number of dual or multi-class share corporations listed on the New York Stock Exchange more than doubled from 1994 to 2001).

A. Governance in Business Organizations

When we think of a corporation, we generally think of the collection of people and assets that make up its everyday business. But in a legal sense, a corporation is a fiction; it is a legal entity created by a government document that has no “independent” existence. Thus, it is perhaps more help to conceive of the corporation as a legal structure designed to allocate rights and duties among the collection of people and assets that give the corporation life. The corporation is generally formed for a business purpose. In the nineteenth century, corporations had a specific corporate purpose within their corporate charter.⁶¹ Even though no specific purpose is legally required today, most corporations are formed by a certain collection of people with a certain collection of assets who believe that forming the corporation will better help them achieve a set of business-oriented goals. They could do this without forming a corporation, but forming a corporation under state law in some ways helps them to effectuate their goals. The corporation is designed to facilitate collective economic activity.

The corporation is not the only form of business organization operating in the U.S. economy: along with corporations, there are sole proprietorships, partnerships, business trusts, limited partnerships, limited liability partnerships, and limited liability companies.⁶² The complexity of these forms is usually seen as existing along a spectrum, with the sole proprietorship being the most basic and the corporation being the most advanced.⁶³ What

⁶¹ NORMAN I. SILBER, *A CORPORATE FORM OF FREEDOM* (2001).

⁶² JAMES D. COX & THOMAS LEE HAZEN, *CORPORATIONS 2* (2d ed. 2003) (including the joint stock company and the partnership association (in a few states)).

⁶³ Within the corporation category, closely-held corporations are sometimes separated from publicly-held corporations, although they are formed through the same state incorporation statutes. Closely-held corporations are identified as those with: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in management. *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505, 511 (Mass. 1975).

separates the corporation from the other forms of business organization? Scholars have isolated five factors which are considered essential to the corporate form: (1) full legal personality, including the ability to bind the firm to contracts; (2) limited liability for owners and managers; (3) shared ownership by investors of capital; (4) delegated management under a board structure; and (5) transferable shares.⁶⁴

In terms of governance, the two essential corporate features are (3) shared ownership by investors and (4) delegated management. This structure is manifest in a tripartite set of players: the shareholders, the board of directors, and the officers. The shareholders are sometimes designated as the “owners” of the firm: they have the right to receive residual profits as well as the right to elect the board of directors.⁶⁵ The directors are, in turn, the locus of authority within the corporation; they are the representatives of the firm when human counterparts to the fictional form are required.⁶⁶ The board does not generally run the business, however; directors generally delegate this power to the officers of the corporation. These officers in turn select the remaining employees. The structure is hierarchical, in that shareholders can vote out directors, directors can fire the officers, and officers can fire the remaining employees.⁶⁷

Other business organizations generally have more flexible governance requirements. In partnership law, the default rule is that each partner has an equal share of the voting power, unless decided otherwise by the partners.⁶⁸ Certainly, partners are free to set up alternative voting structures, and most sophisticated partnerships have complicated methods of aggregating the

⁶⁴ Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439-440 (2001). Cf. CLARK, *supra* note RC1, at 2 (listing four characteristics of the corporation: (1) limited liability, (2) free transferability of investor interests, (3) legal personality, and (4) centralized management).

⁶⁵ This designation is something of a misnomer. See *infra* note ZZZ.

⁶⁶ CLARK, *supra* note RC1, at 21.

⁶⁷ Bainbridge, *Director Primacy*, *supra* note SB1, at 555-58 (discussing the hierarchical nature of corporate structure).

⁶⁸ UNIF. P'SHIP ACT § 18(e), 6 U.L.A. 526 (1995); REV. UNIF. P'SHIP ACT § 401(f) (amended 1997).

preferences of their members. But the default rule has continuing relevance because partnerships may be created without an explicit agreement between the parties.⁶⁹ When the parties have not explicitly agreed to form a partnership, they will not have established a governance framework and thus will be given the default setting. Thus, even in situations where one partner has provided substantially more money or labor to the partnership than the other partners, all will have an equal vote in partnership decisions.⁷⁰

The “one partner, one vote” default rule can be wildly inequitable, at least if voting power is meant to correspond with one’s actual contributions to the enterprise. As an alternative, a court could conduct a simple calculation of the dollars invested by each partner, and votes would be allocated according to the funds invested. Why has the law assented to such a blunt division of power? Perhaps most importantly, the default division of profits and losses (the interest in the residual) is to provide each partner an equal share.⁷¹ Thus, as in the “one share, one vote” system, the (default) voting power is equal to the (default) share of profits and losses. In addition, a partner-oriented default rule is much easier to manage than an investment-oriented rule. A “one partner, one vote” default allocation may provide the best mix of interest aggregation and manageability in sorting out voting power amongst partners.⁷²

⁶⁹ A partnership has been defined as “an association of two or more persons to carry on as co-owners a business for profit.” UNIF. P’SHP ACT § 6(1); REV. UNIF. P’SHP ACT § 202(a) (amended 1997). The definition thus includes individuals who may not have intended to form a partnership. *See, e.g., Bass v. Bass*, 814 S.W.2d 38, 41 (Tenn. 1991) (holding that “it is not essential that the parties actually intended to become partners”).

⁷⁰ The control rights in a partnership extend even to ordinary, everyday matters of the business. UNIF. P’SHP ACT § 18(h), 6 U.L.A. 526 (1995); REV. UNIF. P’SHP ACT § 401(j) (amended 1997).

⁷¹ UNIF. P’SHP ACT § 18(a) (1914), 6 U.L.A. 526 (1995); REV. UNIF. P’SHP ACT § 401(b) (amended 1997), 6 U.L.A. 77 (Supp. 2001).

⁷² *See* Larry E. Ribstein, *The Evolving Partnership*, 26 J. CORP. L. 819, 841-42 (2001) (noting that “[e]quality rules for management . . . suit very closely held firms in which the partners’ combinations of capital, service, and credit contributions can be assumed to equalize”). *But see id.* at 841 (questioning whether partner intent should sometimes overrule the default).

Of course, “one partner, one vote” is only the default rule. Partners who contemplate varying levels of input and interest will generally construct a partnership agreement that allocates votes according to mutual agreement.⁷³ And there is no requirement that each partner must have an equal vote according to that partner’s “share” in the residual profits. Instead, partners are free to divvy up voting power according to contributions, seniority, experience, involvement, and other factors relevant to governance.⁷⁴ There is no scholarly literature saying that partnerships are poorly constructed if they fail to match voting rights to the residual.

The business trust has a similar flexibility in governance. The common law trust has had a rocky history, as it has sometimes been lumped in with partnerships,⁷⁵ and other times it has been judged to be a corporation in trust clothing.⁷⁶ This differential treatment has hampered the use of the trust as a business organization. However, the trust has dominated some types of business enterprises, such as pension and investment funds.⁷⁷ Recently, trust law scholars have argued that the business trust is underrated and that new statutory trusts will provide a new venue for commercial enterprises.⁷⁸

The trust is generally recognized by its strict division between principal and agent, as well as the strong fiduciary duties assumed by the principal. The trust divides its relevant

⁷³ See, e.g., *Day v. Sidley & Austin*, 394 F. Supp. 986, 992 (D.D.C. 1975) (discussing how “statutory rules governing the rights and duties of the partners are ‘subject to any agreement between them’”).

⁷⁴ See *id.* at 988 (discussing the centralized management structure of law firm partnership).

⁷⁵ Cox & Hazen, *supra* note CH1, at 20.

⁷⁶ See Herbert B. Chermiside, Jr., *Annotation, Modern Status of the Massachusetts or Business Trust*, 88 A.L.R.3d 704, 729-30 (1978 & Supp. 2001).

⁷⁷ See John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 Yale L.J. 165, 168-73 (1997).

⁷⁸ *Id.* at 166-67; Robert H. Sitkoff, *Trust as “Uncorporation”: A Research Agenda*, 2005 U. ILL. L. REV. 31, 35. There is an uncertain number of states with statutory trusts. *Id.* at 35 (“The existing literature, such as it is, puts the count of states with general business trust legislation anywhere from seventeen to thirty-four.”). In 1988, Delaware established a statutory trust to some fanfare. DEL. CODE ANN. tit. 12, §§ 3801-3824 (2007).

participants into trustees and beneficiaries (or “beneficial owners”).⁷⁹ Trustees manage the assets of the trust, and the beneficiaries receive the profits of this management. Because trusts were traditionally donative transfers, beneficiaries had no rights or expectations of control over the trustees, despite the trustee’s obligation to act on their behalf. However, the law did provide for trustee oversight. Under common law, the general duty of trustees is to “exercise reasonable care in an effort to preserve the trust property.”⁸⁰ Trustees were thus liable for acting in their own interest or for violating a duty of care far stricter than the duty of care under corporate law. For this reason, the trust was seen as an inappropriate avenue for entrepreneurial enterprises.⁸¹

The new statutory trusts provide for more flexibility in governance, and allow the parties to structure the relationship between trustee and beneficiary as they please.⁸² Thus, theoretically, the commercial trust became the completely contractual enterprise; governance could be structured in any way that the relevant parties desired.⁸³ But such flexibility has thus far

⁷⁹ See, e.g., *id.* tit. 12, §3801 (2007) (defining “statutory trust” as “an unincorporated association which [i]s created by a governing instrument under which . . . business or professional activities for profit are carried on or will be carried on, by a trustee or trustees or as otherwise provided in the governing instrument for the benefit of such person or persons as are or may become beneficial owners or as otherwise provided in the governing instrument.”)

⁸⁰ RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 232, cmt. C (1990).

⁸¹ Steven L. Schwarcz, *The Commercial Trust as Business Entity: Unraveling the Mystery*, 58 Bus. Law. 559, 575-80 (2003).

⁸² See, e.g., DEL. CODE ANN. tit. 12, § 3806(a) (2007) (“Except to the extent otherwise provided in the governing instrument of a statutory trust, the business and affairs of a statutory trust shall be managed by or under the direction of its trustees. To the extent provided in the governing instrument of a statutory trust, any person (including a beneficial owner) shall be entitled to direct the trustees or other persons in the management of the statutory trust.”).

⁸³ See Tamar Frankel, *The Delaware Business Trust Act Failure as the New Corporate Law*, 23 Cardozo L. Rev. 325, 326 (2001) (“Moreover, the [Delaware] Act explicitly invites commercial and manufacturing enterprises . . . to take advantage of this marvelous contract-like organizational form, emphasizing its liberal contractarian approach and the freedom to write into or omit from the trust documents anything they wish, or almost anything.”).

not led to a rush of new firms organized as trusts.⁸⁴ In part, there is difficulty in establishing the background law and default rules for this new form of organization.⁸⁵ But there is no norm of control in commercial trusts, and by extension no norm that beneficiaries have a share of control proportionate to their interests.

The default rules are a bit more structured for the limited partnership, the limited liability partnership, and the limited liability company. These organizations envision participants with stakes in the residual who do not participate in management. For example, limited partnerships must make clear who the managerial partners are, and who the limited partners are.⁸⁶ Limited liability companies have what is known as “chameleon” management: “the firm can choose either direct partnership-type control by the members or centralized control by managers that is closer to, but not as rigid as, the limited partnership format.”⁸⁷ Participants in these enterprises have substantial flexibility in arranging the division of ownership and control rights. Thus, there is likewise no “one share, one vote” norm in these structures. Instead, voting rights are divided amongst the participants according to agreement.

Finally, closely-held corporations have the same basic corporate structure as publicly-held corporations: the shareholders elect the board of directors, and the board appoints the officers who run the corporation. In closely-held companies, however, these roles often overlap, leading to a governance structure more akin to a partnership than a large corporation.⁸⁸ Many closely-held

⁸⁴ *Id.* at 327.

⁸⁵ *Id.* at 328. Steven Schwarcz has argued that because of the background of trust law, “[t]he degree to which assets need to be placed at risk in order to satisfy the expectations of residual claimants thus provides a key to distinguishing commercial trusts from corporations.” Schwarcz, *supra* note SLS1, at 578.

⁸⁶ See UNIF. LTD. P'SHIP ACT § 7 (1916), 6A U.L.A. 336 (1995); REV. UNIF. LTD. P'SHIP ACT § 303 (amended 1985), 6A U.L.A. 144-45 (1995). However, limited partners may be subject to liability as managing partners if they participate in the governance.

⁸⁷ Ribstein, *supra* note LR1, at 843.

⁸⁸ See *Donahue v. Rodd Electrotyping Co. of New England, Inc.*, 328 N.E.2d 505, 511 (Mass. 1975) (defining closely held corporations as having “(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3)

companies have different classes of shares as a method of allocating control amongst different groups of shareholders.⁸⁹ In addition, shareholders may agree to certain voting arrangements, such as the pooling of votes into a voting trust or agreeing to vote along certain lines.⁹⁰ These voting arrangements are often executed to consolidate a group of disparate shareholders into a majority or to provide protection to minority shareholders over certain critical matters.⁹¹ Because of the limited number of shareholders, closely-held corporations often have a shareholder or shareholder with actual majority control. Because of this, corporate law generally protects minority shareholders against undue “oppression.” Although such oppression may relate to the stake in the residual, it more often relates to the ability of minority shareholders to partake in other aspects of the corporate pie – namely, employment.⁹² Thus, the minority oppression doctrine recognizes that even if shareholders are all sharing equally in the profits, a majority may still be oppressing minority shareholders by

substantial majority stockholder participation in the management, direction and operations of the corporation”).

⁸⁹ Preferred stock is particularly common in start-up corporations. Venture capital investors prefer to invest with preferred stock, which converts into common stock with multiple voting shares if certain triggers are reached. William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 892 (2002) (noting that “[c]onvertible preferred stock is the dominant financial contract in the venture capital market”).

⁹⁰ See, e.g., COX & HAZEN, *supra* note CH1, at 388-93; FRANKLIN A. GEVURTZ, *CORPORATION LAW* 486-96 (2000).

⁹¹ Perhaps the most famous example of such a trust involves the Ringling family of circus fame. See *Ringling Bros.—Barnum & Bailey Combined Shows v. Ringling*, 53 A.2d 441 (Del. 1947).

⁹² See, e.g., *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842 (1976) (finding “no legitimate business purpose” to the majority’s decision to suspend a minority shareholder’s salary, fail to reelect him as a director, and fail to appoint him as an officer); *Leslie v. Boston Software Collaborative, Inc.*, 14 Mass. L. Rptr. 379 (Mass. Sup. Ct. Feb. 12, 2002) (minority shareholder terminated from position as treasurer by majority shareholders).

failing to approve a dividend⁹³ or by not providing employment or other opportunities within the company.⁹⁴

Thus, despite the theoretical notion that a corporation is merely a “nexus of contracts” between the various parties in the firm,⁹⁵ the corporation has perhaps the most specific and structured system of governance out of all of the forms of business organization. Business organizations such as commercial trusts, partnerships, and LLCs give their members lots of flexibility to construct the organization as they so desire.⁹⁶ The corporation, however, is run by a board of directors which has been elected by shareholders. This conflict between the flexibility of the model and the strictures of reality presents problems for the justifications behind one-share, one-vote.

B. A Brief History of the “One Share, One Vote”

As discussed above, other forms of business organizations contemplate substantial overlap between those with an interest in the residual and those with managerial control over the corporation. Such overlap is generally not possible in the modern public corporation. Instead, those investors who are given a residual interest must entrust their funds to other individuals who will actually control the enterprise. In order to deal with the greater diffusion of ownership contemplated under corporate law, the system of governance allows the participants to elect a central governing body, which then can make decisions in a more

⁹³ See, e.g., *Naito v. Naito*, 35 P.3d 1068 (Or. 2001) (ordering the implementation of dividend policy).

⁹⁴ For a further discussion of the protection of minority shareholders vis-à-vis the protection of political minorities, see Anupam Chander, *Minorities, Shareholder and Otherwise*, 113 YALE L.J. 119 (2003).

⁹⁵ For a discussion of the “nexus of contracts” theory, see, for example, STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 27 (2002).

⁹⁶ This may explain, in part, the enthusiasm that nexus-of-contracts supporters have for business forms such as LLCs and partnerships. See, e.g., Larry E. Ribstein, *Why Corporations?*, 1 BERK. BUS. L.J. 183, 185 (2004) (challenging “the assumption that the corporate form is optimal for publicly held firms”).

organized and efficient fashion.⁹⁷ Shareholders thus retain a modified form of control in the power to elect their representatives; their representatives, in turn, have actual control over the running of the firm.

How, then, was this control to be shared amongst shareholders? The “one share, one vote” standard seems like a fairly straightforward and natural way of breaking down the power relations between shareholders. However, in the early days of the corporate form, shareholder ownership was not uniformly distributed in the early corporate charters. For much of the nineteenth century, the common law of corporations provided for a default rule of one vote per person.⁹⁸ This method tracked the default partnership rule, in which each partner has a vote no matter his or her financial interest in the partnership. One scholar found that more than a third of a sample of corporate charters from 1825 to 1835 had a “one person, one vote” system of governance.⁹⁹ Other charters provided a “prudent mean,” in the words of Alexander Hamilton, in trying to balance between shareholders and shares.¹⁰⁰ Such charter provisions provided that the votes-per-share would decrease as the individual shareholder got more and more shares; a shareholder with five shares might get five votes, but a shareholder with 100 shares might only get ten votes.¹⁰¹ In establishing a “prudent mean” system for the first Bank of the United States, Hamilton rejected a one share, one vote system on the grounds that it would allow a few large shareholders to “monopolize the power and benefits of the bank.”¹⁰²

Over the course of the nineteenth century, however, corporations moved decisively away from quasi-partnership arrangements. By the end of the 1800s, most states had moved

⁹⁷ See Bainbridge, *Director Primacy*, *supra* note SB1, at 548 (discussing the means of corporate governance through the board of directors).

⁹⁸ Dunlavy, *supra* note CD1, at 1354.

⁹⁹ *Id.* at 1354-55.

¹⁰⁰ *Id.* at 1356.

¹⁰¹ *Id.* at 1357.

¹⁰² ALEXANDER HAMILTON, REPORT ON A NATIONAL BANK, COMMUNICATED TO THE HOUSE OF REPRESENTATIVES, 1st Cong, 2d Sess. (Dec. 14, 1790), *reprinted in* 2 THE DEBATES AND PROCEEDINGS OF THE CONGRESS OF THE UNITED STATES, app. 2032, 2049 (Washington, Gales & Seaton 1834).

away from mandatory or default rules oriented toward limited the power of larger shareholders.¹⁰³ There was a brief period around the turn of the century in which cumulative voting for directors became a tool for protecting small shareholders.¹⁰⁴ And in the early twentieth century, states and corporations moved toward a one share, one vote structure as a progressive response to the increasing number of no-vote shares being issued.¹⁰⁵ The term “shareholder democracy” stems from these efforts to make sure that shareholders had a viable vote, both through the shares and through the corporation’s proxy machinery.¹⁰⁶

The “one share, one vote” movement reached its apex in 1988 at the Security and Exchange Commission’s adoption of Rule 19c-4.¹⁰⁷ The rule required companies listed on the major exchanges to refrain from issuing shares with disproportionate voting rights.¹⁰⁸ Subsequently, however, the rule was struck down by the D.C. Circuit and was never revived.¹⁰⁹ Exchanges now allow companies to issue dual-class shares and still maintain their listings.¹¹⁰ Despite the failure of Rule 19c-4, however, the one-share, one-vote norm remains a touchstone of corporate governance. Shareholder advocacy groups like Institutional Shareholder Services look unfavorably upon dual class structures. An unbalanced system of voting rights is likely to hurt a company’s corporate governance rating, which may in turn affect

¹⁰³ Dunlavy, *supra* note CD1, at 1358-59.

¹⁰⁴ *Id.* at 1362.

¹⁰⁵ Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L. Q. 565, 569 (1991) [hereinafter Bainbridge, *Rule 19c-4*].

¹⁰⁶ Dunlavy, *supra* note CD1, at 1363-66.

¹⁰⁷ 17 C.F.R. § 240.19c-4 (1988), *vacated* Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

¹⁰⁸ At the time, some companies had issued a new class of stock, as a dividend to current shareholders, that provided an abnormally large number of votes per share. However, these new shares were not transferable, and could only be sold if they were converted to regular one-vote shares of common stock. The effect of such an issuance was to provide “lock in” power for long-term shareholders and/or managers. See Bainbridge, *Rule 19c-4*, *supra* note SB2, at 566.

¹⁰⁹ Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

¹¹⁰ See, e.g., NYSE LISTED COMPANY MANUAL, 313.00(B)(1)-(3) Voting Rights (2005).

how institutional shareholders treat the company.¹¹¹ The media has also latched on to the one-share, one-vote refrain as a litmus test for fair treatment of shareholders.¹¹²

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

C. The Theoretical Underpinnings of “One Share, One Vote”

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

If we look at shareholder suffrage in this way, we immediately are struck by the fact that it is only shareholders who are having their preferences aggregated. The corporation encompasses the daily activities of a variety of different players: directors, officers, executives, management, and employees. Moreover, there are a variety of outside “stakeholders” who have interests in the activities of the corporation, akin to shareholders: bondholders, suppliers, customers, even the community at large.

¹¹¹ See, e.g., Kathleen Pender, *Google's Weak Governance Rating*, S.F. CHRON, Aug. 24, 2004, at <http://www.sfgate.com/cgi-bin/article.cgi?file=/chronicle/archive/2004/08/24/BUGBU8D46M1.DTL&type=business> (noting that “Google's low mark was largely a result of its dual-share-class structure, which gives founders and other insiders 10 times as many votes per share as outside stockholders”).

¹¹² See, e.g., Gretchen Morgenson, *One Share, One Vote: One Big Test*, N.Y. TIMES, April 2, 2006.

However, when it comes to aggregating the preferences of the polity, in order to determine the leadership of the corporation, only shareholders are invited to participate. The shareholder franchise only assesses shareholder preferences.

The primary normative justification for shareholder voting is the theory of shareholder primacy. Shareholder primacy is the primary theoretical driver not only for the vote, but also for such key concepts as the fiduciary duties of care and loyalty. Shareholder primacy essentially means that corporations exist to serve the interests of shareholders.¹¹³ Put more specifically, the theory mandates that the corporation be run with the goal of maximizing shareholder wealth.

Shareholder primacy could simply be a democratic legitimacy argument: the corporation has to keep shareholder interests at the forefront, because shareholders are the voting polity. But this puts the cart before the horse: after all, who made the shareholders the voting polity? The choice of this group as the enfranchised citizenry is what needs justifying. A variant of this justification is that shareholders are the corporation's "owners" and thus were entitled to the ownership rights of profits and control.¹¹⁴ However, the ownership justification is also doomed by its circularity: who made the shareholders the "owners"?¹¹⁵ As corporate law commentators have convincingly pointed out, shareholders simply purchase a set of rights from the corporation. The right to vote is made part of the stock ownership "bundle," but a stock could be constructed (and has at times been constructed) without the right to elect directors.¹¹⁶ Even shareholders with the right to vote do not possess many of the rights that traditionally

¹¹³ See D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 277 (1998) ("The structure of corporate law ensures that corporations generally operate in the interests of shareholders.").

¹¹⁴ The classic example of this perspective is Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32-33, 122-26.

¹¹⁵ See, e.g., Lynn Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1190-92 (2002) ("[T]he claim that shareholders own the public corporation simply is empirically incorrect.").

¹¹⁶ See Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. W. L. REV. 687, 694 (1986) (discussing the practice of selling shares without the right to vote).

accrue to property owners—the right to exclude, for example, or the right of possession.¹¹⁷ Labeling shareholders “owners” is no more of a justification for the vote than is labeling them “voters”.

In their foundational work *The Economic Structure of Corporate Law*, Easterbrook and Fischel provided a justification for shareholder primacy beyond simple labels. In looking to ground shareholder primacy in economic theory, they looked to the traditional economic utility rationale of creating the highest level of efficiency or overall social utility.¹¹⁸ Shareholder primacy theory argues that maximizing shareholder wealth will generate the highest amount of surplus and thus will result in the greatest overall social utility.¹¹⁹ This premise returns us to the “nexus of contracts” model.¹²⁰ Instead of being the “owners” of the corporation, shareholders were one group of many whose contracts with one another jointly created the fictional corporate “entity.”¹²¹ However, shareholders were the sole “residual claimants:” that is, their returns were not payable until the other contractual participants—creditors, employees, customers, suppliers—had been fully satisfied.¹²² This perspective assumes that all other claimants have rigidly-set contractual entitlements, such that paying them more than their entitlement would be akin to a gift. Because shareholders are not paid until these set contractual payments have been made, all other claimants received their contractual entitlements, and the shareholders benefited from the maximization of the residual. As Easterbrook and Fischel write:

As residual claimants, shareholders have the appropriate incentives . . . to make discretionary

¹¹⁷ Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 Va. L. Rev. 733, 754 (2007).

¹¹⁸ EASTERBROOK & FISCHEL, *supra* note EF, at 35-39.

¹¹⁹ *Id.*

¹²⁰ EASTERBROOK & FISCHEL, *supra* note EF, at 1-39; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310-11 (1976) (suggesting that nature of firm as nexus for contracting relationships moots discussions of precise corporate boundaries).

¹²¹ EASTERBROOK & FISCHEL, *supra* note EF, at 36.

¹²² *Id.* at 36-37. This perspective assumes that all other claimants have rigidly-set contractual entitlements, such that paying them more would be akin to a gift.

decisions. . . . Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertakings of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion.¹²³

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

Thus, shareholder voting is not the cause of shareholder primacy; it is instead simply one of the reinforcing mechanisms of shareholder primacy. Of course, as has been dogma since the seminal work of Adolf Berle and Gardiner Means, the shareholder vote in publicly-held companies has not been a particularly effectively way of maintaining shareholder primacy.¹²⁴ Shareholder votes have been generally an empty exercise in rubber-stamping the slate of candidates nominated by the board. But this is an oversimplification. At the level of the closely-held corporation, shareholder votes are a much livelier affair. Here, shareholder primacy is generally effectuated directly by the shareholders themselves through the vote. Even in publicly held companies, a majority or even a properly situated minority shareholder has the power to appoint its representatives to the board and thus control the corporation's fate.

It is the power of a "controlling" interest¹²⁵ that drives the law and economics of shareholder voting. At a traditional publicly held corporation, the individual shareholder has little or no motivation to monitor the company or even vote in the election. But when those votes are amassed together into a controlling

¹²³ EASTERBROOK & FISCHER, *supra* note EF, at 68.

¹²⁴ BERLE & MEANS, *supra* note BM1, at 6.

¹²⁵ A majority will have de jure control, but a minority interest may also have de facto control over the corporation. *See, e.g., Kahn v. Lynch Comm. Sys., Inc.*, 638 A.2d 1210 (Del. 1994) (finding ownership of 44% of shares to be a controlling interest).

interest, they can vote out the current board – often immediately.¹²⁶ The shareholders' votes can be amassed through the mechanism of a tender offer – an offer by one entity to buy 50% or more of the company's shares. The market for corporate control imposes the market discipline necessary to effectuate the shareholder primacy norm. If the shareholders are ignored or unhappy, they can sell their shares to another entity that can agglomerate the shares into a majority holding. This new majority holder then can take complete control and make the profits that prior management had failed to generate. In this way, the market for corporate control leads to greater efficiency: the shareholders can sell their shares at a premium, and the acquirer can realize the benefits of control. This potential for market discipline keeps the board and management focused on the shareholders' interests.¹²⁷

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

“One share, one vote” is a “logical consequence” of the theory of shareholder primacy.¹²⁸ The “one share, one vote” rule requires that each share of stock have equal voting weight with all other shares. In this way, the voting interest is equal to the interest in the residual. Shares with disproportionate voting power create skewed incentives. As Easterbrook and Fischel argue, “Those with disproportionate voting power will not receive shares of the residual gains or loss from new endeavors and arrangements commensurate with their control; as a result, they will not make

¹²⁶ DEL. CODE ANN. TIT. 8, § 228 (allowing a majority of shareholders to execute any action that may be taken at a shareholders' meeting (including removal of directors) through a written concurrence of those shareholders).

¹²⁷ See Edelman & Thomas, *supra* note ET1, at 454 (discussing the importance of shareholder votes in the takeover setting).

¹²⁸ EASTERBROOK & FISCHEL, *supra* note EF, at 73 (“Votes follow the residual cost of the firm, and unless each element of the residual interest carries an equal voting right, there will be needless agency cost of management.”)

optimal decisions.”¹²⁹ As a result, those with control will have the incentive to seek disproportionate gains that do not directly inure to the owners of the residual.¹³⁰ The residual will no longer be maximized, discouraging equity investment and leading to a decline in societal efficiency.

A similar concern about incentives lies behind the prohibition on selling a share’s voting rights separately from the share itself. State corporate law does not permit a shareholder to disengage the right to vote from the share and sell it permanently.¹³¹ In addition, there are generally restrictions against buying a vote in a particular election or bribing a shareholder to vote a certain way.¹³² Such restrictions may seem counter to the general corporate law preference for private ordering through contract. But vote selling is problematic for the same reason as disproportionate voting: it disengages control rights from the rights to the residual.¹³³ It may make sense for an individual shareholder to sell the vote, given that the value of the vote for any individual share in a public corporation is close to zero.¹³⁴ However, the sale gives greater control to a holder that does not have an equivalent interest in the residual. To some extent, these problems are similar to those

¹²⁹ EASTERBROOK & FISCHER, *supra* note EF, at 73. See also Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1945-46 (1996) (“The case for the one share, one vote rule turns primarily on its ability to match economic incentives with voting power and to preserve the market for corporate control as a check on bad management.”).

¹³⁰ See Hu & Black, *supra* note HB1, at 851 (discussing concerns that controlling shareholders without a commensurate economic stake in the corporation are more likely to “tunnel” away a disproportionate share of firm value).

¹³¹ See, e.g., *Hall v. Isaacs*, 146 A.2d 602 (Del. Ch. 1958).

¹³² See *Schreiber v. Carney*, 447 A.2d 17, 25-26 (Del. Ch. 1982) (noting that individual instances of vote-buying are “easily susceptible of abuse” and thus “subject to a test of intrinsic fairness”).

¹³³ EASTERBROOK & FISCHER, *supra* note EF1, at 74 (“Separation of shares from votes introduces a disproportion between expenditure and reward.”).

¹³⁴ This is based on the notion that any individual vote has an extremely low probability of affecting the outcome. See Yair J. Listokin, *Management Always Wins the Close Ones*, at 13-14, Yale Law & Economics Research Paper, available at: <http://ssrn.com/abstract=980695> (noting that “management sponsored proposals typically pass easily,” with a mean approval rate of 85 percent).

related to tender offers; individual shares are worth less when sold individually than their per-capita value when agglomerated into a control group. But there is also a separate problem, in that those selling their votes get all of the benefits of the sale but only a fraction of the costs.¹³⁵ At root, the problem of control without equity interest would remain, and all shares would be less valuable.

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

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

III. THE PROBLEMATIC ASSUMPTION OF SHAREHOLDER HOMOGENEITY

In their recent article on encumbered shares, Martin and Partnoy state: “It is simply not true that the ‘preferences of [shareholders] are likely to be similar if not identical.’”¹³⁶ Martin and Partnoy focus on the problems caused by equity derivatives which carve up various shareholder rights into discrete financial securities. However, there are many ways in which shareholders fail to share common interests – many opportunities for conflict along what has been called “horizontal power relations.”¹³⁷ These conflicts are explored further below.

¹³⁵ Ribstein & Kobayashi, *supra* note RK1, at 39 (“Vote buying and selling can, however, be inefficient in some situations because it enables the buyer and the seller to realize gains while losses are incurred by other shareholders.”).

¹³⁶ Martin & Partnoy, *supra* note MP1, at 778 (quoting Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 405 (1983)).

¹³⁷ Dunlavy, *supra* note CD1, at 1351-52 & fig.1.

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

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

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

The structure of the corporation's control mechanisms is ill-equipped to deal with this basic problem. Most corporations are arranged under a "majority rules" system in which each director is elected by a majority vote of all of the shareholders. In some states, the "straight voting" system is counterbalanced by a system of cumulative voting, in which each shareholder has a set of votes to distribute among the entire slate of directors.¹³⁸ Cumulative voting allows for minority shareholders to have representation on the board. But cumulative voting is relatively rare, especially in

¹³⁸ See COX & HAZEN, *supra* note CH1, at 348-51.

Delaware corporations,¹³⁹ and even under cumulative voting the majority shareholder still controls the corporation. The system of “majority control” sets up the fundamental problem of minority shareholders’ lack of control.¹⁴⁰

This structural problem has led to supplemental doctrines intended to ameliorate or eliminate the effects of majority rule. The duty of loyalty, for example, is an implied, mandatory duty for all corporate directors and officers. It requires them to act in the interests of the corporation as a whole, rather than in their own personal interests. Because the duty applies to directors, it applies by extension to majority shareholders, as their board representative will be subject to this duty. However, controlling shareholders also have a duty of loyalty to the corporation’s minority shareholders.¹⁴¹ The duty of loyalty has a structural element, in that conflict transactions can find a safe harbor through approval by a majority of shareholders or independent directors.¹⁴² However, in Delaware such transactions can also survive the conflict through an after-the-fact “entire fairness” test. Thus, there is some flexibility and discretion in the administration of the duty.

The duty of care is also a mechanism for constraining the majority. The duty requires directors and officers to act with the level of ordinary care expected of a reasonably prudent person.¹⁴³ This rule is designed more to counteract agency costs, but it does prevent the majority from running the company in a way that may seem irrational to others. However, the strength of the rule is severely limited by the business judgment rule, which provides that directors and officers are free to use their own business judgment in making managerial decisions.¹⁴⁴ As a result, the duty of care

¹³⁹ See Jeffery N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994).

¹⁴⁰ Note that this is different than the “agency costs” problem which seems to (pre)occupy most corporate law scholars.

¹⁴¹ See *Kahn v. Lynch Comm. Sys., Inc.*, 638 A.2d 1110, (Del. 1994) (“A controlling or dominating shareholder standing on both sides of a transaction . . . bears the burden of proving its entire fairness.”).

¹⁴² E.g., DEL. CODE ANN. TIT. 8, § 144 (2007).

¹⁴³ MODEL BUS. CORP. ACT § 8.30 (2003).

¹⁴⁴ For an example of the discretion given to directors under the business judgement rule, see *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968).

has largely become simply a mechanism for requiring directors and officers to be appropriately informed about the corporation's operations and financial health.¹⁴⁵ In the past, the doctrine of *ultra vires* was also used to cabin the majority's discretion on business matters. The doctrine held that corporate directors and officers were not permitted to act on behalf of the corporation outside the scope of the corporation's purpose. However, given the expansive and non-specific nature of most corporation's "corporate purpose," as designated in the corporate charter, the *ultra vires* doctrine no longer has much effect.

Finally, the doctrine of minority oppression is designed as a backstop in cases involving matters in which the majority generally has discretion to operate. The doctrine is generally applied to closely-held corporations in which shareholders participate in the company as both shareholders and employees. Because there is no outside market for shares in a closely-held corporation, shareholders cannot sell their shares and exit if they disagree with the majority's direction. The difficulty of exit has led some courts to rule that shareholders in a closely-held corporation must treat each other as more akin to partners and must treat each other with the "utmost good faith and loyalty."¹⁴⁶ This duty is defined ambiguously in order to capture a range of discretionary activities that do not breach other fiduciary duties on their face.¹⁴⁷ They generally entail participation in the corporation that is controlled by the majority shareholder but is in some way expected to be shared by minority shareholders. As one court put it: "A shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in

¹⁴⁵ See, e.g., *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

¹⁴⁶ *Donahue v. Rodd Electrotpe Co.*, 328 N.E. 505, 515 (Mass. 1975).

¹⁴⁷ See Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 708 (1993) (noting that minority oppression has been defined as "burdensome, harsh and wrongful conduct," "a visible departure from the standards of fair dealing," and "frustration of the reasonable expectations of the shareholders").

the corporation seek to defeat those expectations and there exists no effective means of salvaging the investment.”¹⁴⁸

In his article on the history of the shareholder primacy norm, Gordon Smith argued that in the nineteenth century the norm served as the foundation for the doctrine of minority oppression.¹⁴⁹ According to Smith, notions of shareholder primacy were actually generated to resolve horizontal conflicts between different groups of shareholders. As he points out, the seminal “shareholder primacy” case – *Dodge v. Ford Motor Co.*¹⁵⁰ – actually involved a dispute between two groups of shareholders about the direction of the company.¹⁵¹ In *Dodge*, the court required Ford Motor to issue dividends to its stockholders. The court used the language of shareholder primacy to compel the controlling shareholder (Ford) to distribute profits to minority shareholders (the Dodge brothers). Refusal to issue dividends is a classic example of minority oppression. Smith pointed out that this development of the shareholder primacy doctrine has much more to do with horizontal relations between shareholders and much less to do with the vertical relations between directors, shareholders, and other corporate constituencies.¹⁵²

Thus, there are a number of “softer” doctrines designed to deal with the structural differences between the interests of majority and minority shareholders. As has been noted, however, finding a balance between these interests can be difficult to achieve, as the majority has legitimate interests in exercising its right of control.¹⁵³ These interests will conflict with those of

¹⁴⁸ *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1179 (N.Y. 1984).

¹⁴⁹ D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998).

¹⁵⁰ 170 N.W. 668 (Mich. 1919).

¹⁵¹ *Id.* at 315-20.

¹⁵² Smith, *supra* note GS1, at 322-23. Smith argued that ultimately the shareholder primacy norm is largely irrelevant to corporate law and corporate business decisions. *Id.*

¹⁵³ See, e.g., *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993) (noting that “well established in our jurisprudence that stockholders need not always be treated equally for all purposes” and arguing it is “inappropriate judicial legislation . . . to fashion a special judicially-created rule for minority investors”); *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842 (1976) (noting that the minority oppression doctrine should not “unduly hamper [the majority’s] effectiveness in

minority shareholders, particularly over issues such as control of the corporation, employment opportunities, dividends, and other means of sharing the surplus.

B. The Problem of Differential Voting Powers Amongst Shares

As discussed above,¹⁵⁴ the efficiency of the “one share, one vote” hypothesis assumes that each share has the right to an equal share of the residual interest. Otherwise, voting shareholders will have different incentives depending on the ratio of voting power to residual interest. A shareholder with strong voting power but little interest in the residual will have different incentives than those with less voting power and greater stake in the profits. Easterbrook and Fischel noted that the “most basic statutory rule” of shareholder voting was the default rule of one share, one vote, and that this was “the same in every state.”¹⁵⁵ They also claimed that agreements to alter this default rule were rare.¹⁵⁶ However, there is evidence that they may have been writing at the high water mark of such a norm, and that differential voting powers amongst shares may be more common than in the past.¹⁵⁷

Easterbrook and Fischel were writing in the wake of the Security and Exchange Commission’s adoption of Rule 19c-4.¹⁵⁸ The rule required that self-regulatory organizations, such as the New York Stock Exchange or NASDAQ, prohibit listed companies from issuing securities that reduced the rights of

managing the corporation in the best interests of all concerned”); Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1688 (1990) (“The application of strict fiduciary duties to close corporations deprives controlling shareholders of the ability to manage the corporation – to use their own property – as they see fit.”).

¹⁵⁴ Part II.A. *supra*.

¹⁵⁵ EASTERBROOK & FISCHEL, *supra* note EF1, at 72.

¹⁵⁶ *Id.*

¹⁵⁷ Martin & Partnoy, *supra* note MP1, at 784-85 (noting that Easterbrook and Fischel derived this conclusion from a “relatively stable period” in which the New York Stock Exchange refused to list companies with nonvoting shares).

¹⁵⁸ 17 C.F.R. § 240.19c-4 (1990), *vacated* Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

existing shareholders. The purpose of the rule was to reinforce the one share, one vote standard by prohibiting the issuance of shares with disproportionate voting rights.¹⁵⁹ However, the rule was struck down by the D.C. Circuit and was never revived.¹⁶⁰ Currently, the exchanges allow companies with multiple-class shares to be listed; however, certain safeguards are required for companies with these shares.¹⁶¹

Although scholars still call for the abolition of dual class voting structures,¹⁶² they appear to be here to stay. Several recent shareholder controversies have involved corporations with dual class shares. Both the New York Times and the Wall Street Journal are controlled by families with shares that have voting power disproportionate to their economic stake.¹⁶³ Critics have claimed that the controlling families do not have the proper incentives because they do not have the same economic risk as the other shareholders.¹⁶⁴ However, such criticisms are subject to the rebuttal that shareholders knew what they were getting when they purchased the stock. Indeed, that is the general justification for multiple-vote or no-vote shares: corporate law should facilitate

¹⁵⁹ At the time, some companies had issued a new class of stock, as a dividend to current shareholders, that provided an abnormally large number of votes per share. However, these new shares were not transferable, and could only be sold if they were converted to regular one-vote shares of common stock. The effect of such an issuance was to provide “lock in” power for long-term shareholders and/or managers. See Bainbridge, *Rule 19c-4*, *supra* note SB2, at 566.

¹⁶⁰ *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

¹⁶¹ See, e.g., NYSE LISTED COMPANY MANUAL, 313.00(B)(1)-(3) Voting Rights (2005).

¹⁶² See, e.g., Troy A. Parades, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1153 (2004) (arguing that dual class voting structures could be prohibited as a way of protecting minority shareholder interests); MORE.

¹⁶³ The Bancroft family is in the midst of selling the Dow Jones Company, parent company to the Journal. Frank Ahrens, *Murdoch Set to Gain Control of Wall St. Journal*, WASH. POST, August 1, 2007.

¹⁶⁴ See, e.g., Rob Keller, *Dual Class Equity Structures*, Risk & Governance Blog, Risk Metrics Group, available at: http://blog.riskmetrics.com/2006/04/dualclass_equity_structuresub.html; Bill Mann, *Dual-Class Shares, Second Class Investors*, Motley Fool, April 14, 2004, available at: <http://www.fool.com/investing/general/2004/04/14/dualclass-shares-secondclass-investors.aspx>.

private ordering, which includes the possibility that certain shareholders will accept less control as part of the bargain. Less control probably means a cheaper price, and shareholders should be permitted to make this bargain if they want to. However, from the perspective of shareholder wealth maximization, shareholders with more control and less risk will have skewed incentives in maximizing shareholder wealth.

In addition to dual class shareholders, there are certain groups of shareholders – primarily holders of preferred shares – who have voting rights that change based on the circumstances. The primary purpose of the preferred share is to give the holder the right to a regular dividend of a specific amount. Holders of preferred shares generally have no voting rights within the corporation on matters such as the board of directors. However, many preferred shares have clauses that give each preferred share the right to vote under certain circumstances, such as the failure to pay the regular dividend. Often, preferred shares are given some multiple of common share votes for each share – for example, ten votes in the election for each share of preferred stock. Thus, once certain circumstances trigger these rights, preferred shareholders go from non-voters to super-voters. Bondholders may also have similar clauses of protection when, for example, the corporation misses a payment.

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

C. The Problem of Shareholder Vote Buying and Voting Trusts

Corporate law generally prohibits shareholders from selling their right to vote without also transferring the underlying interest

in the residual.¹⁶⁵ The converse is also true, although courts have allowed for the theoretical possibility that the seller of stock could retain the vote in order to protect a legal interest.¹⁶⁶ However, there has been a shift in the law with regard to bribery – paying a shareholder to vote a particular way. In the past, vote bribery was not permitted; it was seen as a violation of a shareholder’s duty to other shareholders.¹⁶⁷ Over time, however, the rule has shifted to a more permissive stance.

In *Schreiber v. Carney*,¹⁶⁸ the company was seeking shareholder approval of a corporate restructuring in the wake of a merger. The company, Texas International Airlines, needed shareholder approval, and it needed majority approval from each class of stock, which included not only common stock but also three series of convertible preferred stock. Jet Capital held a majority of shares in one of the preferred stock series as well as warrants for a large number of common shares. Jet determined that if the restructuring went through, it would incur a large tax liability unless it had already exercised the warrants. However, it did not have enough cash on hand to exercise the warrants. Thus, it determined that it would have to vote against the merger. In order to resolve this difficulty, Texas International decided to lend money to Jet so that it could exercise the warrants.

The Delaware Chancery court upheld the loan against a challenge of vote buying. The court recognized two principles behind the general prohibition against vote buying: (1) protecting shareholders against fraud and deceit, and (2) requiring shareholders to exercise their own independent judgment.¹⁶⁹ The

¹⁶⁵ Hall v. Isaacs, 146 A.2d 602 (Del. Ch. 1958).

¹⁶⁶ See, e.g., Commonwealth Assocs. v. Providence Health Care, 641 A.2d 155 (Del. Ch. 1993) (expressing “doubt whether, in a post record-date sale of corporate stock, a negotiated provision in which a beneficial owner/seller specifically retained the ‘dangling’ right to vote as of the record date, would be a legal, valid and enforceable provision, unless the seller maintained an interest sufficient to support the granting of an irrevocable proxy with respect to the shares”).

¹⁶⁷ See, e.g., Cone’s Ex’rs v. Russell, 21 A. 847, 849 (N.J. Ch. 1891).

¹⁶⁸ 447 A.2d 17 (Del. Ch. 1982).

¹⁶⁹ *Id.* at 24. The court cited to *Cone* for the proposition that “[t]he security of the small stockholders is found in the natural disposition of each stockholder to

court found no hint of fraud or deceit in the instant case, as it was in the other shareholders' interests to bribe Jet into voting for the restructuring. In fact, Texas International had secured approval for the loan from the other shareholders.¹⁷⁰ The court recognized that shareholders had different interests and that it may be in the interests of certain shareholders to work with other shareholders in developing a negotiated solution. As for the independent judgment principle, its traditional justification was that "by requiring each stockholder to exercise his individual judgment as to all matters presented, the security of the small stockholders is found in the natural disposition of each stockholder to promote the best interests of all, in order to promote his individual interests."¹⁷¹ However, the court found that this rationale was "obsolete because it is both impracticable and impossible of application to modern corporations with many widely scattered stockholders."¹⁷² Instead, the court held the loan transaction to a standard of entire fairness.¹⁷³

Voting trusts are somewhat analogous to vote buying in that two voters agree to bind their votes to each other, rather than to their independent self-interest. The Delaware corporation statute, for example, allows parties to contract with each other to vote the same way.¹⁷⁴ The statute allows for a great deal of flexibility: one party may agree to vote as directed by another party in exchange for consideration. In addition, parties may put their shares into a voting trust that is then voted by a trustee.¹⁷⁵ What these arrangements demonstrate is that corporations are not simply a mass of like-minded individuals who are all voting based upon the

promote the best interests of all, in order to promote his individual interests." *Cone*, 21 A. at 849.

¹⁷⁰ *Schreiber*, 447 A.2d at 20 ("noting that the other shareholders "voted overwhelmingly in favor of the proposal").

¹⁷¹ *Id.* at 24.

¹⁷² *Id.* at 25 (quoting 5 FLETCHER CYCLOPEDIA CORPORATION (Perm. Ed.) § 2066). *See also id.* ("[A] shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed his fellow stockholders." (citation omitted)).

¹⁷³ *Id.*

¹⁷⁴ DEL. CODE ANN. tit. 8 § 218(c).

¹⁷⁵ *Id.* § 218(a).

same self-interest. Instead, conflicts between shareholders may arise, and corporate law allows for mechanisms to resolve them contractually. Given the emphasis on private ordering in corporation law generally, it would make sense to allow for these private arrangements. However, these arrangements contradict the notion of shareholders as a mass of undifferentiated seekers with a singular goal.

D. The Problem of Hedging the Residual Interest

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

How does this work? The simplest way is to purchase shares in the company while simultaneously “shorting” the stock. The stock can be shorted through equity derivatives that increase in value as the share price falls.¹⁷⁶ Thus, a party will have countervailing interests: the stock will still have its residual attached, but the “short” position will reward a drop in price for the stock. If the short position is strong enough, the shareholder will actually be encouraged to act against the interests of the corporation in order to trigger a decrease in the share price. There are also less extreme possibilities that would nevertheless allow shareholders to vote despite a complex set of interests that do not overlap with other shareholders. For example, in 2004, Perry Corporation bought 9.9% of the shares in Mylan Labs and voted in favor of a merger between Mylan and King Pharmaceuticals.¹⁷⁷ Perry acquired the stake because it owned King, and it wanted Mylan to agree to the merger. However, Perry also hedged its voting stake in Mylan through a series of equity swaps and other

¹⁷⁶ Martin & Partnoy, *supra* note MP1, at 778 & n.14.

¹⁷⁷ Hu & Black, *supra* note HB1, at 828.

undisclosed transactions. Thus, Perry acquired voting power in Mylan while simultaneously hedging the residual interest in Mylan. Perry was sued by another Mylan shareholder for voting without true economic ownership; however, the case was rendered moot when Mylan called off the merger with King.

Another potential for vote buying is through the borrowing of shares specifically around the “record date” – the date on which shareholders are “locked in” as the voting polity for purposes of the election at hand.¹⁷⁸ The purpose of this transaction is to borrow the share specifically for the vote, and then return it to the original owner after the vote. Lending shares for a short period of time is a fairly common practice; it is designed to facilitate short-selling by making the shares available for sale when the short comes due. But if the borrowing is done not to facilitate a short sale, but rather to allow the borrower to vote without economic risk, the practice looks fairly close to vote selling.

Why would shareholders lend their votes to someone else – someone whose interests might be counter to theirs? The main reason is money coupled with ignorance. Financial institutions can lend out the shares for a fee and make money while at the same time keeping the share and the residual. Given the lack of importance or drama in most shareholder votes, these institutions have not really focused on the possibility that borrowers could be targeting shares not to facilitate a short, but rather for the vote. In fact, fund managers have been caught unawares by borrowers who use the vote contrary to the managers’ interests.¹⁷⁹ As the practice becomes more widespread, shareholders will likely take more steps to prevent “vote borrowing.” But the complexity of many of these transactions may make such monitoring more and more difficult.

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

¹⁷⁸ *Id.* at 832.

¹⁷⁹ *Id.* at 834 (discussing share borrowing in the case of British Land, including the role of one fund manager who lent stock unknowingly to an opponent in the contest).

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

Certainly, there are similarities between the interests of a shareholder and the interests of an employee. Both wish the company to perform well. But within the organization, shareholders and employees have different interests when it comes to issues like the level of risk the company should bear, how employees are to be compensated, and how the surplus is to be split. Particularly when it comes to mergers and acquisitions, employees might have very different interests from shareholders if the transaction will bring downsizing or worker replacement.¹⁸⁰ Conversely, employees with shares as well as stock options might choose to vote their shares so as to increase the potential for upside risk.¹⁸¹ Stock options may have led employees to favor a strategy of short-term stock appreciation without due regard for the potential for down-side risk.¹⁸² In the late 1990s, employees may have been more concerned about their stock and stock option

¹⁸⁰ See Matthew T. Bodie, *Workers, Information, and Corporate Combinations: The Case for Non-Binding Employee Referenda for Transformative Transactions*, 58 WASH. U. L. REV. (forthcoming 2008) (discussing employee interests in merger and acquisition decisions).

¹⁸¹ Martin & Partnoy, *supra* note MP1, at 792.

¹⁸² Since stock options offer the chance for the holder to buy the stock at a certain strike price, the options are worth the same (nothing) whether the stock drops to \$1 below the strike price or \$100 below the strike price. This incentive scheme may have led to management and employees undervaluing excessive downside risk, including the risk that financial misreporting would come to light. See Matthew T. Bodie, *AOL Time Warner and the False God of Shareholder Primacy*, 31 J. CORP. L. 975, 995-97 (2006 [hereinafter Bodie, *AOL Time Warner*]).

holdings than their job; but as shareholders, they had different interests than those shareholders who did not also hold options.¹⁸³

Pension fund shareholders have received significant attention lately for their increasingly visible activities in the realm of corporate governance. Teaming with other institutional investors, pension funds have taken the lead in promoting greater shareholder involvement in corporate issues such as shareholder nominations for directors and approval of executive compensation. For example, AFSCME was the lead plaintiff in a recent Second Circuit decision permitting shareholders to propose easier shareholder access for board nominations.¹⁸⁴ Some commentators who are otherwise committed to shareholder primacy draw a distinction between these activist pension fund shareholders and other shareholders.¹⁸⁵ Since pension funds are often run by unions, commentators accuse pension fund leaders of pursuing their own pro-worker agenda when it comes to shareholder proposals, directors votes, and other shareholder matters.¹⁸⁶ Manager discretion is limited, as ERISA requires pension fund managers to run the fund in the interests of the fund participants. But there is room within this discretion to pursue various agendas that have ramifications beyond simply corporate governance and share price.

Specifically singled out are pension funds for government employees. For years the biggest player in the corporate governance arena was CalPERS, the pension fund for approximately 1.5 million California state and local employees. The CalPERS Board is made up of directors elected by the fund participants, directors appointed by the governor and other state

¹⁸³ Matthew T. Bodie, *Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5*, 88 IOWA L. REV. 539, 546-50 (2003).

¹⁸⁴ *American Fed'n of State, County & Mun. Employees v. American Intern. Group, Inc.* 462 F.3d 121, 129-30 (2d Cir. 2006).

¹⁸⁵ See Larry Ribstein, The "shareholder democracy" scam, Ideoblog, Oct. 27, 2006, at http://busmovie.typepad.com/ideoblog/2006/10/the_shareholder.html. ("It should be obvious to anybody who cares to look past the rhetoric that the unions are seeking bargaining leverage on behalf of their members, and to ensure their own survival. They are *not* seeking to represent the interests of investors generally.").

¹⁸⁶ Editorial, *Conflicted in California*, WALL ST. J., May 11, 2004, at A18 (complaining about labor's efforts to "hijack" corporate governance for their own ends).

officials, and ex officio members who are state officials or agency appointees.¹⁸⁷ CalPERS has long been active in corporate governance and has its own “Focus List” of companies that had questionable corporate governance practices.¹⁸⁸ However, CalPERS has been criticized for pursuing its governance agendas overzealously and for caring more about workers’ rights than profits. For example, the CalPERS corporate governance campaign against Safeway was characterized as a “jihad”; critics maintained it was a response to Safeway’s harsh stance in labor negotiations, rather than to real concerns about underperformance.¹⁸⁹ In addition, some critics have accused CalPERS of using its power to advance the political interests of those who serve on its board.¹⁹⁰

Despite the potential conflicts between employee-affiliated shareholders and the other shareholders, commentators have not called for such shareholders to be deprived of the franchise. And for the most part, the law has encouraged management and employee ownership of equity interests in their corporation. In fact, the notion of “pay for performance” led to the exponential growth of stock options as a compensation device throughout the 1990s.¹⁹¹ Agency costs would be reduced and investors would feel more secure, it was argued, if investors knew that the managers also had their income riding on the success of the stock. But such

¹⁸⁷ See CalPers, Structure and Responsibility, at: <http://www.calpers.ca.gov/index.jsp?bc=/about/organization/board/structure-responsibilities.xml>.

¹⁸⁸ CalPERS, 2007 Focus List, at: <http://www.calpers-governance.org/alert/focus/2007/default.asp>.

¹⁸⁹ Editorial, *Conflicted in California*, *supra* note WSJ1, at A18 (“Ostensibly Calpers is upset about underperformance, but the real problem seems to be the tough stance the grocery chain took against labor during a recent strike.”).

¹⁹⁰ Aaron Lucchetti & Joann S. Lublin, *CalPERS Targets Directors Who Neglect Holders*, WALL ST. J., 2004 (“The campaign is being fueled partly by the political ambitions of Phil Angelides, California’s state treasurer and a Calpers board member, who is considering running for governor of California in 2006.”). See also Sundeep Tucker, *Few Mourn Belligerent President’s Departure*, FIN. TIMES, Dec. 1, 2004 (discussing the firing of former CalPERS president Sean Harrigan for, in part, “going off on political tangents”).

¹⁹¹ Michael C. Jensen & Kevin J. Murphy, *CEO Incentives--It's Not How Much You Pay, But How*, 68 HARV. BUS. REV. 138 (1990).

shareholders clearly have different interests than their non-employee counterparts.

F. The Problem of Defining “Wealth Maximization”

The assumption behind the “one share, one vote” norm is that shareholders have a uniform interest in wealth maximization. Since all shareholders are entitled to part of the residual, they all have an interest in maximizing the size of that residual. The notion that shareholder wealth maximization is not only a goal for the corporation, but in fact the only legitimate goal, has become the dominant normative theory of the corporation. Indeed, Hansmann and Kraakman have proclaimed the primacy of this view: “There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.”¹⁹²

However, even assuming a mass of shareholders with no other complications or interests, there are still difficulties in implementing the notion of shareholder wealth maximization. The main problem is: when? What is the time horizon for wealth maximization? Hansmann and Kraakman specify “long-term shareholder value” but do not define it. And in fact, shareholders have radically different time horizons for the “maximization” of their shareholder wealth.¹⁹³ There may be some shareholders who buy the stock at the IPO and hold it until it passes to their heirs and assigns. But there are other shareholders who hold the stock for a day, a week, a month. There are some shareholders who also have options – they want to max out on the stock at the option exercise date.¹⁹⁴ There are some shareholders who must sell the share once

¹⁹² Hansmann & Kraakman, *supra* note HK1, at 439.

¹⁹³ See Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579-83 (2006) (discussing the different financial interests of short-term and long-term shareholders).

¹⁹⁴ And they want to get the option at the stock’s lowest point. Many companies have been accused of gaming the system by backdating the option’s strike date to a day with a lower price. For a discussion of the backdating scandal, see David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561 (2007).

it drops out of a particular index.¹⁹⁵ There are some shareholders who have yearly or quarterly profit margins to meet, and they need the stock to rise to meet those horizons. There are some shareholders who buy the stock looking to take it over, and then either buy all of the stock or walk away; other shareholders buy the stock on a bet that the takeover attempt will succeed.

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

Because uncertainties multiply as the time horizon lengthens, shareholder primacy becomes more and more meaningless as it stretches from short to long. Paying high wages, to employees or corporate management, can be justified based on retention of key talent or reduction in turnover. Customer good will justifies slashed prices or expensive research and development. As one commentator has argued, “the mantra of shareholder wealth maximization has no distinctive meaning and policy implications if

¹⁹⁵ Index funds track a particular index; they must manage the fund to mirror the composition of the index. See Shimon B. Edelstein, Note, *Indexing Capital Gains for Inflation: The Impacts of Recent Inflation Trends, Mutual Fund Financial Intermediation, and Information Technology*, 65 BROOK. L. REV. 783, 811-12 (1999) (discussing index funds); Peter N. Hall, Note, *Bucking the Trend: The Unsupportability of Index Provider’s Imposition of Licensing Fees for Unlisted Trading of Exchange Traded Funds*, 57 VAND. L. REV. 1125, 1126 (2004) (describing the composition of exchange traded funds, which may track certain indices by having a sampling of stock from a particular index).

it is not interpreted to mean maximization of short-term value.”¹⁹⁶ However, maximization of short-term shareholder value leads to short-time horizons that can cripple business planning and stability. Moreover, a short-term focus encourages corporate fraud and misreporting designed to bolster the stock price now (the possibly bad consequences to come later).¹⁹⁷

In addition, shareholders with a diversified portfolio have different interests than shareholders with most of their wealth tied up in one company.¹⁹⁸ Fully diversified shareholders, who have been referred to as “universal owners,”¹⁹⁹ have a stake in corporate success as a whole. Their notion of wealth maximization will be quite different from a shareholder who has invested entirely in a particular company. Scholars have argued that portfolio shareholders prefer a policy of portfolio value maximization, rather than individual firm value maximization.²⁰⁰ In contrast, undiversified shareholders have an incentive to oppose transactions that maximize wealth for all shareholders (by increasing the value of one firm by more than the decrease in value at the shareholders’ firm).²⁰¹ Professors Ribstein and Kobayashi have used this argument in support of a hands-off approach to vote selling and buying.²⁰² According to this view, vote buying may be necessary to allow diversified shareholders to pull off transactions that actually hurt shareholders at the company. The portfolio shareholders would buy the votes necessary to carry off the transaction as long as the transaction creates overall positive value for the portfolio.²⁰³

¹⁹⁶ Margaret M. Blair, *Directors’ Duties in a Post-Enron World: Why Language Matters*, 38 WAKE FOREST L. REV. 885, 890 (2003).

¹⁹⁷ Bodie, *AOL Time Warner*, *supra* note MB1, at 997-98.

¹⁹⁸ Anabtawi, *supra* note IA1, at 583-85.

¹⁹⁹ JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM* 3, 21 (2000).

²⁰⁰ Robert G. Hansen & John R. Lott, Jr., *Externalities and Corporate Objectives in a World with Diversified Shareholders/Consumers*, 31 J. FIN. & QUANT. ANALYSIS 43, 44 (1996).

²⁰¹ *Id.*

²⁰² Larry E. Ribstein & Bruce Kobayashi, *Outsider Trading as an Incentive Device*, 40 U.C. DAVIS L. REV. 21, 44-45 (2006).

²⁰³ *Id.* (noting that such “costly manipulation” may be useful in overcoming “interference from self-interested managers or undiversified shareholders”).

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

G. The Problem of "Corporate Social Responsibility"

Finally, we must consider the possibility that shareholders will, in fact, choose something other than wealth maximization as their goal for the corporation. The goal of wealth maximization is assumed, on both descriptive and normative grounds, to be the sole corporate purpose that shareholders desire. Descriptively, shareholders are assumed to be rational actors, and thus are assumed to desire the maximization of their utility. Although scholars recognize that utility can come in many forms, the role of "shareholder" is seen as easily translatable into a wealth-based utility model. In other words, since shareholders invest money in stock in order to make more money (through dividends and appreciation of stock price), their utility in holding the stock is derived solely from their financial appreciation from the stock. This reality is also normatively the optimal outcome, since (economic theory provides) self-interested shareholders will push to maximize the corporation's residual profits, which will maximize the social wealth generated by the corporation.

While many have questioned the normative story of shareholder wealth maximization, it has been assumed to correctly portray the reality of shareholder interests. However, there is increasing evidence that not all shareholders maximize their utility through a program of shareholder wealth maximization. Instead,

some shareholder may gain utility through lower profits but higher levels of some other good. There are a few anecdotal episodes of this occurring at individual companies. For example, a number of Disney shareholders hold the stock because of their fondness for Disney animation, particularly the historical works such as Bambi and Snow White.²⁰⁴ These shareholders supported the efforts of Roy Disney, the nephew of Walt Disney, to restore and maintain the company's tradition of animation and family entertainment.²⁰⁵ Many of these shareholders attend annual meetings in order to celebrate their association with the company.²⁰⁶ And they may have played an important role in the no confidence vote against Michael Eisner in 2004, in which 43% of shareholders voted to withhold their votes from him.²⁰⁷ Eisner had angered some traditionalists by diversifying Disney's holdings and failing to continue Disney's animation successes of the 1990s.²⁰⁸

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

²⁰⁴ See, e.g., Frank Ahrens, *Roy Disney's Quest*, WASH. POST, Feb 21, 2004, at A1 (noting that Disney stock "is widely held by individual shareholders"); Peter J. Howe, *Shareholders Hold the Key to the Kingdom*, Boston Globe, March 3, 2004 (describing "hundreds of thousands of Disney fanatics who also own stock"); *Obsessive Fans Join the Disney Proxy Fight*, ASSOC. PRESS, March 3, 2004 (" . . . [H]ardcore Disney fans own stock in the object of their devotion. Those stakes may be just a few shares apiece, but multiplied by thousands of fans across the county, they help make Disney one of the most widely held stocks on Main Street.").

²⁰⁵ Howe, *supra* note PH1.

²⁰⁶ JAMES B. STEWART, *DISNEYWAR* 508 (2005) (discussing the thousands of shareholders who attended the 2004 shareholders meeting).

²⁰⁷ Kenneth N. Gilpin, *Disney Dissidents Rebuke Eisner, Denying Him 43% of the Vote*, N.Y. TIMES, March 3, 2004.

²⁰⁸ See *id.* ("During the course of his remarks, Roy Disney suggested that under Mr. Eisner's direction the Disney name and its products had lost their luster and unique character.").

behavior so that concerns such as worker rights, the environment, poverty, and illness become factors in management's calculus.

As individuals, most shareholders do not generally have sufficient power to justify the time and energy required to vote their shares according to their overall social utility, as opposed to just their wealth. However, increasingly investors are putting their money into "socially responsible" funds – funds that invest in companies that meet certain social responsibilities targets or thresholds.²⁰⁹ By the end of 2005, approximately \$2.3 trillion was invested in funds targeted towards socially responsible companies, up from \$635 billion in 1995.²¹⁰ Such funds often underperform the market as a whole.²¹¹ However, their popularity attests to the desires of some investors to promote companies that adhere to certain principles beyond wealth maximization. As the number of socially responsible funds increases, investment houses are diversifying the types of such funds to appeal to a broader variety of investors. Along with funds favoring companies based on labor or environmental policies, there are funds that invest based on Catholic social teaching as well as funds that invest in companies based on the money that those companies give to Democratic candidates.²¹²

Socially responsible investing is just a small share of the market now, and it may be that the overwhelming desire of most shareholders is simple wealth maximization. But it may also be that the new era of socially responsible consumerism and investing, when coupled with the shareholder democracy movement, will lead shareholders to support policies that do not

²⁰⁹ See Henry Blodget, *The Conscientious Investor*, ATLANTIC, October 2007, at 78.

²¹⁰ Jeff Brown, *Save the Earth, Sacrifice your Returns?*, WASH. POST, May 13, 2007, at F01. Of course, this may be so because "performance" is measured along one metric—profitability—that fails to capture additional investor or societal utility generated by investment in such funds.

²¹¹ *Id.* ("For the 12 months ended April 30, for example, such funds investing in big-company stocks returned 11.63 percent, compared with 12.28 percent for all big-stock funds. For funds investing in mid-size companies, socially minded versions returned 7.65 percent over the period, compared with 10.24 percent for all funds.")

²¹² *Id.*; see also Blodget, *supra* note HB1, at 80-82 (discussing the categorization difficulties of socially responsible investing).

directly correlate with wealth maximization. In the end, a system based on and legitimated by shareholder control must admit of the possibility that shareholders may choose not to maximize profits.²¹³ If shareholders choose this route more frequently, a normative theory that justifies the shareholder vote based on the efficiency of shareholder wealth maximization may in fact find that the shareholder vote is no longer the best tool for achieving shareholder wealth maximization.

H. The Problem of Market Hegemony

The norm of shareholder wealth maximization may actually reveal a shortcoming in the application of economic theory shareholder voting (and many other aspects of commercial behavior).²¹⁴ Most economic models, for example, treat profit maximization as the sole objective of corporations; non-market values are to be (appropriately) ignored.²¹⁵ And, indeed, there is plenty of evidence that most corporations really do make decisions based on these profit-maximizing considerations.²¹⁶ Shareholders tend to vote on those considerations.²¹⁷ Consumers, too, tend to focus on bottom-line considerations then making their marketplace decisions. Factors such as price and product quality tend to dominate consumer choice; the “social values” of the corporations figures little, if it all, in those

²¹³ Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. 1431, 1433 (2006) (“Managers can promote shareholders’ interests without maximizing profits to the extent the shareholders have some objective other than profit maximization.”).

²¹⁴ Much of the thinking in this subsection draws upon the thinking of Stephen Ellis, *Market Hegemony and Economic Theory* (forthcoming 2008).

²¹⁵ See, e.g., Norman Barry, *Controversy: Do Corporations Have Any Responsibility Beyond Making a Profit?*, 3 J. MARKETS & MORALITY 100 (2000); Patrick Primeaux & John Steiber, *Profit Maximization: The Ethical mandate of Business*, 13 J. BUS. ETHICS 287 (1994).

²¹⁶ See, e.g., Sandra Black & Elizabeth Brainerd, *Importing Inequality? The Impact of Globalization on Gender Discrimination*, 57 IND. & LAB. REL. REV. 540 (2004); Ann Schwartz-Miller & Wayne Talley, *Motor Bus Deregulation and the Gender Wage Gap: A Test of the Becker Hypothesis*, 26 E. ECON. J. 145 (2000).

²¹⁷ See Ellis, *supra* note XX.

decisions.²¹⁸ Everyone, it seems, focuses on the bottom line when acting in market contexts. This is in marked contrast, by the way, to how people behave in political elections—indeed, it has been suggested that people’s votes in political elections are driven by generalized “values” while their votes in the marketplace are driven by individual “tastes.”²¹⁹

Markets, then, are hegemonic: people act for personal gain, and other values are only reflected in what they do with that gain.²²⁰ Both proponents and critics of markets agree on this point—their disagreement turns on whether this is a good or a bad thing.²²¹ Either way, however, economic theory should be able to account for the fact of market hegemony. The traditional explanation is that acting on non-market values (social values, prejudices) is costly, and market competition drives out high-cost competitors.²²² But this is just bad economics. Standard economic theory tells us that markets should reflect consumer values, not shape them. And those preferences, taken as given, show that people care about a large variety of things, many of which are not self-focused.²²³ While economic theory does a good job explaining what happens when people act solely on bottom line considerations, this just shows that the theory presupposes market hegemony, not that it explains it.

Standard economic theory may not give a good account of market hegemony because it posits that people are consulting all of their desires and beliefs when making decisions. In other words, their utility functions are univocal and fixed (or, to the extent they change, they change slowly).²²⁴ For that reason, economic theory lacks the resources to explain why, for example, people appear to consult their “other-regarding” values in some (non-market) situations and not in

²¹⁸ Lois Mohr *et al.*, *Do Consumers Expect Companies to be Socially Responsible? The Impact of Corporate Social Responsibility on Buying Behavior*, 35 J. CONSUMER AFFAIRS 45, 67 (2001).

²¹⁹ See KENNETH J. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (2d ed. 1970).

²²⁰ See Ellis, *supra* note XX

²²¹ See *id.*

²²² See MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 109-10 (1982).

²²³ See Ellis, *supra* note XX.

²²⁴ See Grant M. Hayden & Stephen E. Ellis, *Law and Economics After Behavioral Economics*, 55 KAN. L. REV. 629 (2007).

other (market) situations. The “on-again, off again” nature of people’s preferences is also unlikely to be adequately captured by some of the basic extensions of economics, like the various versions of the multiple-selves model.²²⁵ A more convincing extension of economics, however, is one that posits that people do not consult their entire set of preferences when making decisions, but instead rely on a proper subset of their interests.²²⁶ This would account for the highly contextual nature of action generally, and further explain why people seem to be attending to only bottom-line considerations when making decisions in market contexts.

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

IV. THE PROBLEMATIC ASSUMPTION OF SHAREHOLDER PREFERENCE AGGREGATION

In the modern corporation, voting rights are limited to shareholders and are often parsed out on a one share, one vote basis. Both of these limitations on the corporate franchise are premised on the belief that shareholders have a homogeneous interest in the corporation. As discussed in the previous section, however, shareholder interests diverge widely along many

²²⁵ *See id.*

²²⁶ *See id.*

different axes. The premise of the argument, in other words, is false.

But even if the premise of shareholder homogeneity were true—even if shareholders had some unique, coherently similar interest in the corporate residual—many of the arguments made from that premise are flawed. In other words, the justifications for existing corporate voting structures are often flawed in both their inception *and* execution. This section examines one of the principal lines of reasoning from shareholder homogeneity to voting restrictions to make this point.

A. The Argument from Arrow's Theorem

One argument, especially popular among those with a law and economics bent, relies on the centerpiece of social choice theory: Arrow's Impossibility Theorem. Frank Easterbrook and Daniel Fischel provide a typical account:

There is another reason why only one class of participants in the venture commonly holds dispositive voting rights at one time. The voters, and the directors they elect, must determine both the objectives of the firm and the general methods of achieving them. 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. If a firm makes inconsistent choices, it is likely to self-destruct. Consistency is possible, however, when voters commonly hold the same ranking of choices (or when the rankings are at least single-peaked).²²⁷

This argument, however, fundamentally misconstrues the Arrow's Theorem and attendant social choice literature.

²²⁷ EASTERBROOK & FISCHEL, *supra* note XX, at XX, *citing* KENNETH J. ARROW, *SOCIAL CHOICE & INDIVIDUAL VALUES* (1963) and DUNCAN BLACK, *THE THEORY OF COMMITTEES AND ELECTIONS* (1958).

Arrow's Theorem holds that no social choice procedure can simultaneously satisfy four relatively undemanding conditions of democratic fairness and guarantee a transitive outcome.²²⁸ The first condition, nondictatorship, demands that no single person's preference order determines the social preference order regardless of what others prefer.²²⁹ The second condition, Pareto efficiency, requires that if everyone prefers one alternative over another, then the social choice procedure must reproduce that ordering.²³⁰ The third condition, universal admissibility, demands that the social choice procedure works with any possible set of individual preference orders.²³¹ The final fairness condition, independence from irrelevant alternatives, requires that the introduction of a new "irrelevant" alternative into the preference profile does not affect the relative orderings of the other alternatives.²³² The logical condition of transitivity guarantees that the social choice function will produce a complete and transitive social preference order: if A is preferred to B, and B to C, then A must be preferred to C.²³³

²²⁸ See KENNETH J. ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES 22-31, 51-58 (2d ed. 1963); see also NORMAN FROHLICH & JOE A. OPPENHEIMER, MODERN POLITICAL ECONOMY 19-23 (1978) (summarizing the assumptions, conditions, and conclusions of the theorem); PETER C. ORDESHOOK, GAME THEORY AND POLITICAL THEORY: AN INTRODUCTION 62-65 (1986) (providing a concise outline of a proof of the theorem); Grant M. Hayden, Note, *Some Implications of Arrow's Theorem for Voting Rights*, 47 STAN. L. REV. 295, 297-99 (summarizing the conditions of fairness and logicity) (hereinafter "Hayden I"); Grant M. Hayden, *The Limits of Social Choice Theory: A Defense of the Voting Rights Act*, 74 TULANE L. REV. 87, 99-102 (1999) (same) (hereinafter "Hayden II").

²²⁹ See WILLIAM H. RIKER, LIBERALISM AGAINST POPULISM: A CONFRONTATION BETWEEN THE THEORY OF DEMOCRACY AND THE THEORY OF SOCIAL CHOICE 295 (1982); Hayden I, *supra* note XX, at 297; Hayden II, *supra* note XX, at 101.

²³⁰ See RIKER, *supra* note XX, at 117-18; Hayden I, *supra* note XX, at 297; Hayden II, *supra* note XX, at 101.

²³¹ See RIKER, *supra* note XX, at 116, 297; Hayden I, *supra* note XX, at 298; Hayden II, *supra* note XX, at 101.

²³² See RIKER, *supra* note XX, at 118; Hayden I, *supra* note XX, at 298-99; Hayden II, *supra* note XX, at 101. The term "irrelevant" is not intended to be pejorative, but instead refers to an alternative outside the set from which a group must choose that does not alter the desirability of the other alternatives relative to each other. See Hayden II, *supra* note XX, at 101.

²³³ See RIKER, *supra* note XX, at 119, 297; Hayden I, *supra* note XX, at 299; Hayden II, *supra* note XX, at 101-02.

The contrary—an intransitive preference order where A is preferred to B, B to C, and C to A—is referred to as a voting cycle, and indicates an inability of the social choice procedure to declare a winner, at least one that is meaningful.²³⁴

With respect to shareholder voting rights, then, the argument from Arrow's theorem is as follows. The theorem tells us that we cannot devise a corporate voting procedure that meets all of Arrow's fairness conditions and, at the same time, guarantees a consistent (i.e., acyclical) outcome. Something—either one of the fairness conditions or a guaranteed transitive outcome—has to give. The fairness condition of universal admissibility requires that people be allowed to vote regardless of their particular preferences. But adhering to that condition by allowing groups of people with dissimilar preferences to vote in corporate elections will result in inconsistent corporate decision-making, which, in turn, would cause a corporation to “self destruct.” Thus, to avoid such an outcome, we should restrict voting rights to groups with similar interests. (This straightforwardly violates the condition of universal admissibility, but, again, something has to give.) Shareholders, given their homogeneous interest in the corporate residual, fit the bill. Thus, restricting voting rights to shareholders avoids corporate disaster.

This argument from Arrow's Theorem is deeply flawed. It is based on a limited understanding of the theorem and it overestimates both the likelihood and impact of voting cycles in corporate elections. In the end, the argument amounts to little more than opportunistic hand-waving.

B. Shortcomings of the Argument from Arrow's Theorem

There are several reasons why Arrow's Theorem doesn't provide much of a foundation for shareholder primacy. First, shareholder agreement on the goal of wealth maximization, even if true, does not indicate agreement on how best to achieve that goal. More specifically, it does not mean that shareholders have the same preference rankings with respect to candidates for

²³⁴ See Hayden I, *supra* note XX, at 299; Hayden II, *supra* note XX, at 101-02.

directorships. (If it did, there would be no reason to have elections in the first place, since we could just ask one of the shareholders to tell us these shared preference rankings of the group.) Shareholders may, and often do, wildly disagree over the proper course of action for their corporation. And even if they were to agree on the direction for their corporation, they may well have very different ideas about which candidates would best effectuate it.²³⁵ Because Arrow's Theorem operates on the level of individual preference orders over an array of alternatives (here, candidates), underlying agreement on the general goal of the corporation does little to ensure that a particular voting system will be free from Arrowian intransitivities.

Second, even if shareholder homogeneity with respect to profit maximization reduced the incidence of cycles in corporate director elections, that isn't a powerful argument in favor of allowing only shareholders to vote. The theorem shows no social choice procedure can simultaneously fulfill the four conditions of democratic fairness and one condition of logicity, but the theorem says nothing about which condition should be sacrificed when designing a voting structure. That decision depends on an assessment of the costs associated with sacrificing one of the conditions of democratic fairness and, on the flip side, the practical likelihood and costs associated with intransitive outcomes. And those who use Arrow's theorem to argue in favor of restricting voting rights to shareholders have not made the case for their choice of conditions to sacrifice.

Because Arrow's theorem applies to all social choice functions, including all corporate voting systems, we know that a voting system where shareholders alone may cast votes must violate one of the conditions of democratic fairness or transitivity.²³⁶ And it does: restricting voting rights to shareholders because of their purported agreement with each other is a straightforward violation of the condition of universal

²³⁵ Also missing is an argument of why underlying agreement on profit maximization make it more likely that shareholder preferences are single-peaked with respect to director candidates. More on this below.

²³⁶ See Hayden I, *supra* note XX, at 299-304 (providing examples of how the Condorcet method, the amendment procedure, the Borda count, and cumulative voting systems all fall prey to Arrow's Theorem).

admissibility. That condition, remember, demands that a voting procedure work with every permutation of voter preferences over a set of alternatives. And like the other fundamental requirements of democratic fairness, universal admissibility is relatively uncontroversial. Giving up this condition—by restricting individual preference orders—runs counter to a fundamental democratic principle: people should not be declared ineligible to vote because of their opinions.

And, just to be clear, this is not one of those situations where people with an interest in an election, to whom we would otherwise extend the right to vote, just naturally happen to have preferences that, collectively, do not produce intransitivities.²³⁷ In those situations, the condition of universal admissibility is not sacrificed by denying anyone the right to vote from the outset. Because the voters encounter no prior restraint on their preference orders, the principal justification for universal admissibility—the immorality of denying the ballot to people with certain preference orders—is not implicated. Sacrificing universal admissibility in such situations sacrifices very little. Here, however, the argument made here is that people other than shareholders, even if they have an interest in an election, should be denied the right to vote from the outset because they have preferences orders that, when combined with those of the shareholders, may produce a voting cycle. The argument, then, implicates the full weight of the justification behind the condition of universal admissibility.

Given the obvious democratic cost of disenfranchising interested voters because of their opinions, the argument that Arrow's Theorem inevitably leads us to restrict voting rights to shareholders is not at all compelling. If you're willing to sacrifice universal admissibility, why not further restrict voting rights to

²³⁷ See, e.g., Hayden I, *supra* note XX, at 312 (arguing that the racial bloc voting requirements of certain claims under the Voting Rights Act may represent a case of "naturally occurring" spectrum agreement that decreases the incidence of cycling); Hayden II, *supra* note XX, at 109-32 (arguing that the level of spectrum agreement required in Voting Rights Act claims, while not complete, is sufficient to reduce the incidence of cycling to near zero). As will be discussed below, many groups of people associated through a polity or a corporation may have sufficiently common reference points to greatly reduce the incidence of intransitivities.

those who agree on the precise direction that the corporation should go, or, better yet, on the slate of directors to take it there? (After all, that kind of agreement, unlike a shared goal of profit maximization, may actually guarantee a transitive outcome.) Or why not sacrifice one of the other conditions of democratic fairness? Restricting the vote to shareholders is certainly not the only choice procedure that may eliminate the possibility of cyclical results—one could also have a system where the shareholder named Matt Bodie chooses the directors (which, despite the obvious upside, violates nondictatorship) or a system where the directors are randomly chosen (which violates Pareto efficiency). The point here is that the case for sacrificing universal admissibility in this instance has not been made, and we're really just left with the question we started with: should voting rights be restricted to shareholders?

C. The Likelihood and Impact of Corporate Voting Cycles

The argument is all the more surprising given that it does not really analyze the likelihood or cost of intransitive results. As it turns out, the likelihood of cyclical outcomes, even when voting is not limited to shareholders, is probably quite small, and the cost of such outcomes, when they do occur, is probably negligible (and certainly not likely to cause a corporation to “self destruct”). This is true for several reasons.

Initially, we should note that empirical observations across a broad range of voting mechanisms have failed to discover the large number of intransitivities initially predicted by social choice theory.²³⁸ This is probably because those early predictions were based on the assumption that all individual preference orders were equally likely to occur in a preference profile—that individual

²³⁸ See Scott L. Feld & Bernard Grofman, *Partial Single-Peakedness: An Extension and Clarification*, 51 PUB. CHOICE 71, 71 (1986) (explaining that “empirical observations of a wide variety of actual collective decisionmaking processes indicate that cyclical majorities are very rare”); Bernard Grofman, *Public Choice, Civic Republicanism, and American Politics: Perspectives of a “Reasonable Choice” Modeler*, 71 TEX. L. REV. 1541, 1553 (1993).

preference orders were somehow randomly distributed.²³⁹ With randomly distributed preference profiles, for example, in a large election with as few as six alternatives, almost one-third of the possible preference profiles produce intransitive outcomes.²⁴⁰ Without that assumption, however, the predicted frequency of cycles varies tremendously, and there are several aspects of real-world preference profiles that greatly increase the likelihood of transitive outcomes.

One condition of a preference profile that ensures transitive outcomes is something loosely referred to as spectrum agreement.²⁴¹ Spectrum agreement occurs when all voters have a common spectrum upon which they array their preferences. This should not be confused with agreement on the order of those alternatives. Take, for example, a case where all the individuals rank candidates based on whether the candidates for corporation director promise to maximize profits (one end of the spectrum) or to minimize profits (the other end of the spectrum). There are three candidates running for office—a profit maximizer (p), a wastrel (w), and some evenhanded chap in between (m). Voters who want to maximize profits will most prefer candidate P and least prefer candidate W, with M somewhere in between. Conversely, voters who want to throw money away will most prefer W, followed by M, with P last. Moderate voters will have preference orders of M-P-W or M-W-P, depending on whether they are closer to the profit or wastrel side of the spectrum. Although these voters rank the candidates in different orders, their preferences can all be aligned along the same profit maximizing-profit minimizing spectrum. No voter, for example, would rank

²³⁹ See Richard G. Niemi & Herbert F. Weisberg, *A Mathematical Solution for the Probability of the Paradox of Voting*, 13 BEHAV. SCI. 317, 321 (1968).

²⁴⁰ See *id.* at 322 & tbl.2.

²⁴¹ See Hayden I, *supra* note XX, at 306-07; Hayden II, *supra* note XX, at 107-108. Although the term spectrum agreement seems to imply some express understanding between voters, it is enough that voter preferences may be arrayed on a common continuum, regardless of whether the voters agreed ahead of time or, indeed, even know about it. For a more specific definition of the necessary conditions for transitivity, see notes XX-XX, *infra*, and accompanying text.

the moderate candidate last, as agreement on the spectrum precludes such an ordering.

This type of spectrum agreement is important because it is a sufficient condition of transitivity. When all voters align the alternatives on a common spectrum, a simple majoritarian voting procedure will produce a transitive social ordering.²⁴² This is true despite the fact that the voters vehemently disagree on relative merits of the candidates; indeed, the earlier example included voters who wanted profits maximized and those who wanted profits minimized. But so long as there is agreement on the spectrum, an acyclic result is guaranteed.

Spectrum agreement of this sort may be described in a variety of technical ways, all of which constitute a sufficient condition for transitive outcomes. For example, a group of individual preference profiles may be “single-peaked” if there is a single horizontal ordering (a spectrum) where every one of the individual orders may be arranged such that each has a most desired alternative and prefers other alternative less as they are further from his ideal point.²⁴³ The outcome of simple a simple majority vote is guaranteed to be transitive, and the winner will be the ideal point of the median voter.²⁴⁴ The same sort of outcome is true of profiles that are, analogously, single-caved or polarized.²⁴⁵

A second, related condition of transitivity occurs when a preference profile is “value restricted.”²⁴⁶ A triple of alternatives is value restricted if at least one alternative is never first, middle, or last in every individual’s preference order.²⁴⁷ The example mentioned earlier—with the profit maximizer, wastrel, and moderate—involved a preference profile that was both single-

²⁴² See RIKER, *supra* note XX, at 123-28.

²⁴³ See DUNCAN BLACK, *THE THEORY OF COMMITTEES AND ELECTIONS* 19-25 (1958); DUNCAN BLACK & R.A. NEWING, *COMMITTEE DECISIONS WITH COMPLEMENTARY VALUATION* 19-28 (1951); Duncan Black, *On the Rationale of Group Decision-Making*, 56 *J. POL. ECON.* 23 (1948).

²⁴⁴ See BLACK, *supra* note XX, at 126-29.

²⁴⁵ See *id.*

²⁴⁶ See Amartya K. Sen, *A Possibility Theorem on Majority Decisions*, 34 *ECONOMETRICA* 491, 492-93 (1966).

²⁴⁷ See *id.*

peaked (on the array of profit maximizing or minimizing) and value restricted (candidate *m* was never ranked last).

One potential drawback to these various indicia of spectrum agreement is that they must be complete in order to guarantee transitive outcomes.²⁴⁸ If, for example, even one voter in an otherwise value-restricted preference profile ranks an alternative where she shouldn't (the rank order that made the profile value-restricted to begin with), the guarantee of a transitive outcome disappears.²⁴⁹ For this reason, one early commentator explained that "the various equilibrium conditions for majority rule are incompatible with even a very modest degree of heterogeneity of tastes, and for most purposes are probably not significantly less restrictive than the extreme condition of complete unanimity of individual preferences."²⁵⁰ Perhaps, then, we should still be wary of the possibility of cyclical outcomes in our voting procedures.

Fortunately, later work in social choice theory has shown that the likelihood of transitive outcomes does not wholly depend upon the assurance of complete spectrum agreement. Instead, much lesser degrees of voter homogeneity may be sufficient. Richard Niemi, for example, proved that a larger proportion of single-peaked or otherwise value restricted preference orders increased the probability of an acyclic result.²⁵¹ This is especially true, counterintuitively, as the number of voters increases.²⁵² His result was confirmed by later studies using other measures of social

²⁴⁸ See Feld & Grofman, *supra* note XX, at 72-73 ("[I]f even one individual has non-single-peaked preferences then there can be a paradox of cyclical majorities"); Richard G. Niemi, *Majority Decision-Making with Partial Unidimensionality*, 63 AM. POL. SCI. REV. 488, 488 (1969) ("[T]he preference ordering of every individual must be single peaked' for 'majority voting [to] yield a transitive social ordering").

²⁴⁹ See Hayden II, *supra* note XX, at 125-26 (providing an example of a preference profile where sixteen of seventeen preference orders are single-peaked yet a majority vote produces an intransitive outcome).

²⁵⁰ Gerald H. Kramer, *On a Class of Equilibrium Conditions for Majority Rule*, 41 ECONOMETRICA 285, 285 (1973).

²⁵¹ See Niemi, *supra* note XX, at 488.

²⁵² See Niemi, *supra* note XX, at 493-94; Hayden II, *supra* note XX, at 127-28. This is counterintuitive because the likelihood of transitive outcomes decreases as you increase the number of individuals in a randomly chosen profile. See Niemi, *supra* note XX, at 493-94.

homogeneity.²⁵³ And it was supported by other work that looked at preference profiles as a whole, which concluded that society often acts in a way that is more ideological than the individuals that compose it.²⁵⁴ Overall, then, it turns out that “[t]he [voting] paradox can be very satisfactorily avoided if common frames of reference are widespread but far less than unanimous.”²⁵⁵

There is a wide range of political and sociological reasons why members of societies will exhibit a large degree of spectrum agreement. Most democracies, for example, require a degree of consensus at their formation, and common socialization may shape individual frames of reference.²⁵⁶ (This may explain why there are so few observed cycles in the political arena.) Those reasons would apply with particular force in corporate elections, which, after all, involves an organization designed to facilitate certain kinds of economic activity. The various categories of people interested in the organization may disagree about many aspects of its governance, but very likely share the common frames of reference that lead to transitive election results. There is good reason to believe, in other words, that the number of intransitivities in corporate director elections is likely to be quite low.

Further, the case has not been made that the occasional intransitivity would really do much harm, and certainly not that it would result in a “firm [that] makes inconsistent choices” leading it to “self destruct.”²⁵⁷ Initially, a large proportion of intransitive results are middle or bottom cycles that still allow us to pick clear winners despite producing cycles involving lower ranked candidates. But, more important, there is a difference between an Arrowian-type of inconsistency in the election of a board member and a firm that makes inconsistent choices. First, most voting

²⁵³ See, e.g., Dean Jamison & Edward Luce, *Social Homogeneity and the Probability of Intransitive Majority Rule*, 5 J. ECON. THEORY 79, 84-86 (1972); Peter C. Fishburn, *Voter Concordance, Simple Majorities, and Group Decision Methods*, 18 BEHAV. SCI. 364, 371-72 ((1973); Hayden II, *supra* note XX, at 128-30.

²⁵⁴ See Feld & Grofman, *supra* note XX, at 73-79; Hayden II, *supra* note XX, at 130-31.

²⁵⁵ Niemi, *supra* note XX, at 494.

²⁵⁶ See FROHLICH & OPPENHEIMER, *supra* note XX, at 19-20.

²⁵⁷ EASTERBROOK & FISCHER, *supra* note XX, at XX.

systems are structured in a way that produces a winner, regardless of whether an intransitivity may mean that a slightly altered voting sequence or procedure may have produced a different winner. So the firm wouldn't suffer for lack of directors. Second, even if the candidate that was the product of an intransitive result somehow held views that did not adequately reflect the views of the voters, she is only one of, say, eleven directors. There is no argument made that the presence of such a director would somehow produce further intransitivities when the board itself makes various decisions. And even in that situation it is unclear what inconsistent board decisions would mean, exactly, or how they would translate into the destruction of the firm. In other words, one has to tell a fantastic story in order to move from an occasional intransitivity in a board election to a firm that makes self-destructive choices, one that is so fantastic as to be completely implausible.

At this point, then, it is clear that shareholders do not have homogeneous interest in profit maximization. And even if shareholders did have a homogenous interest in profit maximization, it does not directly translate into the kind of agreement on candidates necessary to avoid intransitive results in corporate elections. Further, even if shareholder homogeneity did translate into the requisite agreement on candidates, restricting voting rights to shareholders involves sacrificing a fundamental condition of democracy in a situation where the likelihood of intransitive results is already negligible. The argument for restricting corporate voting rights to shareholders, then, is far from compelling.

V. THE CONSEQUENCES OF HETEROGENEITY

The notion of shareholder homogeneity is critical to the normative premise behind "one share, one vote." Easterbrook and Fischel emphasized that shareholders are likely to have "similar if not identical" interests because "the shareholders of a given firm at a given time are a reasonably homogenous group."²⁵⁸ This homogeneity has several beneficial effects. First, it gives all

²⁵⁸ EASTERBROOK & FISCHEL, *supra* note EF1, at 70.

shareholders an equal incentive to monitor agency costs so as to reduce such costs for all shareholders.²⁵⁹ If shareholders have different interests, they will have different incentives to reduce agency costs incurred by the corporate form. Second, shareholders with the same interests will have the same objectives for the firm. This consistency of purpose will prevent the firm from becoming a war zone of competing preferences. Easterbrook and Fischel, along with others, have argued that this consistency amongst voter preferences is the key to the stability and prosperity of the corporate form.²⁶⁰

Moreover, shareholder homogeneity would solve the interpersonal utility problem discussed in Part I. In a democratic state, voting systems based on “one person, one vote” assume that each person has an equal interest and set of preferences to be expressed in the election. This assumption is almost certainly incorrect.²⁶¹ With shares, however, we can define each person’s interests and preferences in a corporate election as the number of shares that they hold. Like landowners in a “one acre, one vote” water district, shareholders have an interest in the company that is clearly defined: it is the percentage of residual they are entitled to based on the number of shares they hold. If we define a shareholder’s utility as the interest in the residual, a shareholder’s voting power is perfectly correlated with her interest in the residual.

We know, however, that shareholders are not, in fact, homogenous. As discussed above,²⁶² all of the following types of shareholders have interests beyond the residual: majority shareholders, shareholders with disproportionate voting rights,

²⁵⁹ Martin & Partnoy, *supra* note MP1, at 776 (noting that the notion of “one share, one vote” is based on “agency costs considerations”); Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. 1103, 1121 (2002) (noting that any rule other than one share, one vote “wastefully increases the agency costs associated with the corporate form”).

²⁶⁰ EASTERBROOK & FISCHEL, *supra* note EF1, at 69-70. *See also* HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 62 (1996) (“Investors-owned firms have the important advantage that their owners generally share a single well-defined objective: to maximize the net present value of the firm’s earnings.”).

²⁶¹ Hayden, *supra* note XX, at 236-47.

²⁶² *See supra* Part III.

members of voting trusts, bribed shareholders, hedged shareholders, and employee and management shareholders. In each case, the shareholder has interests that threaten to override the shareholder's individual interest in the residual.

Moreover, shareholder heterogeneity is not simply a matter of shareholders with discrete competing interests. There is also heterogeneity amongst shareholders with respect to their definition of wealth maximization. As discussed above,²⁶³ the definition of wealth maximization can be quite different for different shareholders. There is the time horizon issue: at what point is wealth to be maximized? A hedge fund looking for a quick return is different than an index fund looking to stay in the stock as long as it is listed. There is also the question of the diversified portfolio: to what extent is the shareholder seeking to maximize this individual stock or across the portfolio? This divide has led some commentators to suggest a normative system of portfolio wealth maximization, rather than share wealth maximization.²⁶⁴ Relatedly, shareholders have different risk preferences and may have different tastes for the corporation's approach to risk based on the ratio of their holdings in the individual firm compared to their overall holdings.²⁶⁵ Shareholders might agree on the goal of wealth maximization and might also share risk and time horizon preferences, but they still might very well disagree about choices the corporation makes in these areas.²⁶⁶

²⁶³ See Part III *supra*.

²⁶⁴ Hansen & Lott, *supra* note HL1. See also Daniel J.H. Greenwood, *Fictional Shareholders: For Whom are Corporate Managers Trustees*, *Revisited*, 69 S. CAL. L. REV. 1022, 1056 (1996) (discussing the differences between the "corporate law" fictional shareholder and the "portfolio investor" shareholder).

²⁶⁵ For example, an investor that owns \$50,000 in stock in company A and has \$100,000 overall in his portfolio will have different risk preferences for the firm than will a shareholder who has \$50,000 in stock in company A and has \$10 million overall in her portfolio. The declining marginal utility of wealth also means that the performance of company A has less effect on the utility of the second shareholder utility, even though both shareholders have the same number of shares.

²⁶⁶ For example, Hewlett-Packard shareholders recently battled over the wisdom of the merger between Hewlett-Packard and Compaq. Michael Brick & Steve Lohr, *Fiorina Claims Victory in Hewlett-Compaq Proxy Battle*, N.Y. TIMES, March 19, 2002. Hewlett-Packard director Walter Hewlett battled the rest of the

Furthermore, the notion that shareholders have a shared interest in wealth maximization is a simplifying assumption. Shareholders are heterogeneous with respect to their utility preferences in that these preferences do not match up directly with wealth. Shareholders – when assessed as individual people – all have individual utility preferences that go beyond maximization of one’s wealth. In their role as shareholder, individuals may put these interests aside and focus solely on wealth maximization. But as the growth of socially responsible investing demonstrates, shareholders may find room to seek non-wealth utility in the corporate setting.

If it seems far-fetched that most shareholders have such heterogeneity, it is only because shareholders in publicly-held companies have no avenues for displaying such heterogeneity. The panoply of shareholder concerns and interests are on constant display in closely-held corporations: there are conflicts over dividend schedules, management staffing, executive salaries, corporate culture, and product development. When shareholders have real power to change corporate policy, they exercise this power in a variety of ways. However, non-controlling shareholders in public corporations cannot generally effectuate changes in corporate policy through their power to vote.²⁶⁷ The miniscule voting power held by most properly diversified shareholders is only part of the problem. In board of directors elections, shareholders only have a choice if an opposition slate is running against the incumbent board. Such a campaign would require the opposition to invest in expensive proxy materials and disclosure.²⁶⁸ If there is no opposition, then the shareholder’s vote has no effect on the corporate leadership structure.

company’s board and management over the merger, ultimately losing in a close election. Both sides agreed that the merger should be judged on its impact of Hewlett-Packard’s success, but they disagreed about whether the merger would help accomplish that goal. Hewlett and the company spent an estimated \$100 million in their efforts to persuade shareholders. Brick & Lohr, *supra* note BF1.

²⁶⁷ Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 676, 682-94 (2007) (describing the lack of effective shareholder voting power).

²⁶⁸ *Id.* at 688-91 (discussing how proxy costs may run to “hundreds of thousands of dollars”).

Thus, the notion of a monolithic shareholder primacy norm is effectuated not by shareholder democracy, but instead by shareholder apathy. Shareholders in a public company have long been divorced from real control of the firm.²⁶⁹ Thus, most shareholders in public companies are rationally uninterested in exercising their voting in an informed manner. The time and costs associated with researching how best to exercise their preferences would greatly outweigh the utility they would gain from voting in a largely meaningless election. As such, most shareholders will not become properly informed and thus will not use the vote to further their disparate interests. Instead, share voters generally tend to follow the directions of the board and management, when they bother to vote at all.²⁷⁰

Shareholders' inability to exercise their control rights results in a power vacuum at the center of the firm. The incumbent board and management are well-placed to occupy that vacuum. The shareholder primacy norm acts as a counterweight on behalf of the shareholders – a norm that the board and management are expected to follow for the benefit of the shareholders. But it is important to remember that the norm of shareholder wealth maximization is a fictional placeholder developed to replace the actual interests of the shareholders.²⁷¹ If shareholders truly expressed their preferences through their votes, there would be no need for the norm of residual maximization. Instead, the board and management would be expected to follow the actual preferences of shareholders, rather than simply a presumed wealth maximization preference.

Thus, we see the strange cycle that Easterbrook and Fischel, amongst others, have used to justify shareholders as the sole franchisees. Shareholders, we are told, will single-mindedly focus on increasing the residual as their sole preference for corporate

²⁶⁹ BERLE & MEANS, *supra* note BM1.

²⁷⁰ See, e.g., Yair J. Listokin, *Management Always Wins the Close Ones*, at 13-14, Yale Law & Economics Research Paper, available at: <http://ssrn.com/abstract=980695> (noting that “management sponsored proposals typically pass easily,” with a mean approval rate of 85 percent).

²⁷¹ Greenwood, *Fictional Shareholders*, *supra* note DG1, at 1052 (“For fictional shareholders, whatever else the people behind them may want, all want to maximize the value of their shares.”).

policy. Because it is in the interests of all corporate stakeholders that the residual be maximized, we should give power to those who have a single-minded focus on such an outcome.²⁷² However, this single-minded focus is simply an assumption. And in reality, the varying interests of shareholders do not comport with the notion of a shareholder electorate with one homogenized goal. Thus, neither the means nor the ends hold up: shareholders will not all have the same preferences, and thus they will not all seek to effectuate those standards in lock-step voting patterns.

It is for this reason that the shareholder primacy norm has been described as a tool for constraining horizontal conflict amongst shareholders, rather than a tool for maintaining shareholder power over other corporate stakeholders. As Gordon Smith has described, the shareholder primacy norm developed as a response to minority oppression.²⁷³ The oppression doctrine prevents the controlling shareholder from pursuing her own individual interests; she instead must seek to maximize the value of the shares of the corporation as a whole. In this way, the controlling shareholder is constrained against following her own (heterogeneous) interests and must look to benefit all shareholders equally.²⁷⁴ The “shareholder primacy” norm, accompanied by equitable anti-oppression doctrine, is necessary because the power of the franchise will not mitigate this problem; in fact, it is the cause of the problem. The shareholder primacy norm is, in effect, a way of forcing homogeneity onto a very diverse set of shareholder interests.

Viewed this way, the shareholder franchise is not justified on the grounds of their own preference for wealth maximization. Instead, the shareholder franchise is simply one tool in the corporate law arsenal for enforcing the norm of shareholder wealth maximization.²⁷⁵ Presumably, there are some issues on which

²⁷² Easterbrook & Fischel, *supra* note EF2, at 403.

²⁷³ Smith, *supra* note GS1.

²⁷⁴ *Id.*

²⁷⁵ Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1750 (2006) (“Like many intracorporate contracts, however, the shareholder wealth maximization norm does not easily lend itself to judicial enforcement except in especially provocative situations. Instead, it is enforced indirectly through a complex and

most or even all shareholders would agree, and thus the vote allows shareholders to exercise collective power over the composition of the board or the completion of a certain transaction. However, the shareholder primacy norm is about more than just the vote. The norm is indifferent or even hostile to the preferences of actual shareholders. Instead, the norm assumes that shareholders all prefer wealth maximization and then requires the corporation to be run accordingly.²⁷⁶

Because shareholder preferences are irrelevant to shareholder primacy, true shareholder democracy is actually a threat to the shareholder wealth maximization norm. If let loose to express their actual preferences, shareholders might express their preferences for a variety of interests beyond shareholder wealth maximization.²⁷⁷ Perhaps this explains the recent move of scholars such as Stephen Bainbridge, who supports the goal of shareholder wealth maximization but argues against greater shareholder input.²⁷⁸ Bainbridge bases his argument primarily on the need for centralized and largely unreviewable discretion in order to maximize efficient business operations.²⁷⁹ According to

varied set of extrajudicial accountability mechanisms, of which shareholder voting is one.”)

²⁷⁶ Greenwood, *Fictional Shareholders*, *supra* note DG1, at 1052 (“It follows, then, that the separation of ownership and control is not a vaguely illegitimate deprivation of the rightful prerogatives of ownership, but rather a supremely sensible application of the division of labor.”); *id.* at 1053 (“We have come then to a solution to the shareholder puzzle. The fictional shareholder reduces politics to administration.”).

²⁷⁷ *Id.* at 1052-53 (“If the corporation were run by and for real people, it would be a hotbed of political controversy. . . . If the real people disagree with the fictional representation, the real people may simply be disregarded as not real shareholders.”).

²⁷⁸ See, e.g., Bainbridge, *Director Primacy and Shareholder Disempowerment*, *supra* note SB1; Stephen M. Bainbridge, *Director Primacy: the Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2002).

²⁷⁹ Bainbridge, *Director Primacy and Shareholder Disempowerment*, *supra* note SB1, at 1749 (“Active investor involvement in corporate decisionmaking seems likely to disrupt the very mechanism that makes the widely held public corporation practicable: namely, the centralization of essentially nonreviewable decisionmaking authority in the board of directors. The chief economic virtue of the public corporation is . . . that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with

Bainbridge, shareholders should only have limited voting rights: “shareholder voting is properly understood not as a primary component of the corporate decisionmaking structure, but rather as an accountability device of last resort, to be used sparingly, at most.”²⁸⁰ Instead, the corporation requires “the centralization of essentially nonreviewable decisionmaking authority in the board of directors.”²⁸¹ As long as the directors operate within the shareholder wealth maximization norms, their decisions in leading the company will be left alone.

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

numerous employees, managers, shareholders, creditors, and other constituencies.”).

²⁸⁰ *Id.* at 1750. According to Bainbridge, this limited right is negotiated through contract. *Id.* (“[S]hareholders have certain contractual rights, which include the requirement that directors maximize shareholder wealth as their principal decisionmaking norm.”). However, to the extent that corporations are creatures of state law, Bainbridge’s contractual analysis fails to justify shareholders as the sole participants in the corporate franchise as set by state law.

²⁸¹ Bainbridge, *Limited Shareholder Voting Rights*, *supra* note SBLSVR, at 626.

CONCLUSION

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

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

Because of the theoretical weaknesses of the traditional justifications for "one share, one vote" and the shareholder franchise, corporate law scholars need to reconsider our foundational conceptions of the corporation. We must consider both proxy strength and manageability in determining whether the right to vote would be a proper expression of utility interests by a particular class of stakeholders. We should consider both categorical and temporal dimensions of voting rights in making our determinations.²⁸² To be

²⁸² In looking at various interests, there will be a temptation to consider a static model, in which various factions are constantly pitched in the midst of the same battles. However, interests change over time and depending on the situation. Different corporate factions will have different arrays of alliances. Perhaps even

true to social utility, we must allow for the expression of monetary and non-monetary utility in our preference aggregation. Finally, we must consider how interests and preferences can be expressed and protected through the entire corporate structure. As noted in Part I, whether one votes or not is just the initial question. The meaning of the vote is defined by what is being voted on, what percentage of votes is required to take action, the preferences and interest of other voters in the election. Although the corporate polity is generally constructed as a majority vote of shareholders as to each position on the board, there are a number of ways in which the polity could be reconstructed to measure preferences.

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

more importantly, the identities and preferences of the stakeholders themselves will change over time. Voting in the corporate context must be considered over time, rather than through a one-round model. Cf. Adam B. Cox, *The Temporal Dimension of Voting Rights*, 93 VA. L. REV. 361, 364 (2007) (rejecting the position that “a narrow temporal frame is required for evaluating voting rights claims”).