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Vote Buying and Corporate Law

Robert Charles Clark*

In this article, Professor Clark delineates the major functions of shareholder voting rights, analyzes the benefits and dangers which may attend shifts in voting power, and assesses various ways that legal rules can magnify or regulate these benefits and dangers. He concludes that the purchase of proxies should be permitted unless an objector can prove (1) that it will, in the particular case, present substantial danger that the corporation or some of its shareholders will be treated unfairly and (2) that any increase in the corporation's value which may result from the vote buying will not outweigh the dangers presented.

INTRODUCTION

WELLINGTON ROLLS,1 president of Creative Mutual Fund, is fuming over the refusal of Sleepy Company’s management to arrange an acquisition of Sleepy by a larger company.2 Rolls believes that several potential suitors are available who would pay up to $60 per share for a majority interest in Sleepy. Sleepy stock is trading at $30. The company is publicly held. Creative Mutual (the Fund) owns three percent of Sleepy’s stock, and there are no dominant shareholders. Rolls does not want the Fund itself to attempt a takeover of Sleepy because to do so would jeopardize the Fund’s status under the Investment Company Act and the Internal Revenue Code.3 Furthermore, Rolls believes that no potential acquirer would be willing to conduct an unfriendly takeover because of the stringent requirements of state anti-takeover stat-

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1. For a characterological portrait of Rolls, see J. OSBORN, THE ASSOCIATES (1979).
2. The incident described in the text occurs after Rolls leaves his law firm to head one of the firm’s clients.
3. See Investment Company Act of 1940 (Company Act), §§ 5(b)(1), 13 (a)(1), 15 U.S.C. §§ 80a–5(b)(1), –13(a)(1) (1976); I.R.C. §§ 851(b)(4), 852. An acquisition by the Fund of a majority interest in Sleepy might require a vote by the Fund’s shareholders and might also cause the Fund to lose its eligibility for the conduit-type income tax treatment given “regulated investment companies.” Id. § 852. In order to receive this tax treatment, the Fund cannot invest more than 5% of its assets in a single issuer, nor can it own more than 10% of a single issuer’s outstanding voting stock. Company Act, § 5(b)(1), 15 U.S.C. § 80a–5(b)(1); I.R.C. § 851(b)(4). To exceed these limits requires a vote of the Fund’s shareholders. Company Act, § 13(a)(1), 15 U.S.C. § 80a–13(a)(1). Whether the Fund would have to jeopardize its eligibility for conduit-type tax treatment in order to acquire up to 10% of Sleepy’s stock depends on the size of the Fund’s assets. A huge mutual fund might be able to take over a small company without using more than 5% of its assets.
utes. Thus, he would like to solicit enough proxies to elect a new slate of Sleepy directors at the next annual shareholders' meeting. The new directors would immediately arrange an acquisition. Rolls is willing to make all disclosures and filings which may be required by any federal or state securities law. He is, however, worried that a simple proxy solicitation either will not succeed or will not be worth the expense if successful. He therefore wants to sweeten the deal by offering a cash payment of $1 per share, payable after the next annual meeting, to any shareholders who give proxies to the Fund. He anticipates that this incentive would lead many shareholders to read their proxy materials and to give the Fund their proxy; some might even give a proxy without doing any investigation at all.

Is Rolls' plan prohibited by federal and state corporate law?

4. See generally Note, Securities Law and the Constitution: State Tender Offer Statutes Reconsidered, 88 YALE L.J. 510, 514 nn. 28 & 29 (1979) (citing 36 statutes and outlining their substantive and disclosure requirements designed to protect shareholders of target companies). The battle over the validity of these statutes has not yet been definitively resolved.


7. If insurgents try to win a proxy contest solely by argument and persuasion, the costs of carrying on the argument long enough and elaborately enough to prevail may exceed the gain the insurgents hope to achieve, especially if each item in the propaganda war must be mailed to a very large number of shareholders. Machtinger, Proxy Fight Expenditures of Insurgent Shareholders, 19 CASE W. RES. L. REV. 212, 213 (1968). See E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL 12 (2d ed. 1968).

8. Payment would be made after the meeting because shareholders may be able to revoke the proxies given to the Fund at any time before they are exercised. See Roberts v. Whitson, 188 S.W.2d 875 (Tex. Civ. App. 1945) (mutual promises held to be insufficient consideration to make pooling arrangement irrevocable).

Additionally, Rolls will want to provide in the offer that if more than the number of proxies needed for control are submitted, the Fund will buy some from all submitting shareholders on a pro rata basis.

To see how Rolls' plan could be effective, assume that Sleepy has 10 million shares outstanding, and 500,000 shareholders. Since the Fund already owns 3% of the shares, or 300,000 shares, it needs to obtain proxies for an additional 4,701,000 shares to obtain control. At $1 per share, it will spend only $4,701,000 on sweetening the deal, plus an additional amount, perhaps $500,000, on preparing and mailing the solicitation. The total of these amounts, $5,201,000, is still far less than the gain that the Fund expects if the merger is approved, which would be 300,000 shares at $30 per share, or $9 million. Depending on how confident the Fund feels about successfully arranging such a merger, its contest expenditures might be significantly greater than those postulated.

9. No federal statute expressly forbids such conduct.

10. Some statutes explicitly forbid shareholders from selling their votes or exchanging their proxies for money or "anything of value." E.g., N.Y. BUS. CORP. LAW § 609(e) (McKinney 1978). Courts have sometimes refused to enforce voting agreements on the ground that they constituted impermissible vote selling. E.g., Macht v. Merchants Mortgage &
Should it be? Rolls wants to buy shareholder votes. His motives are pure: he wants to gain temporary control of Sleepy Company in order to cause it to do something that will greatly increase the company's value to all shareholders, including those who sell their votes. But doesn't the plan have a bad odor? In the political context, society views explicit vote buying as illegal and immoral. In the corporate world, on the other hand, one who buys common shares of a company is in fact purchasing not only a residual economic interest in the company, but also a share of the voting power. And, in hard-fought proxy contests, the rivals may "pay off" shareholders by wining, dining, and entertaining them, in the hope that such activities will enable shareholders to think more sensibly about the issues and persons involved in the struggle. But even in the corporate context, pure vote buying—where payment is in cash and nothing but votes are bought—may strike the observer as deeply suspect. Are such feelings mere phantasms of minds trained to revere traditional democratic ideals and practices, or do they have substance?

The corporate lawyer may object that this hypothetical is odd, since it rarely makes economic sense for a person to purchase voting control without also buying a greater economic interest in the company, and that, therefore, we need not consider how the law should treat pure corporate vote buying. The point, however, is that the process of trying to produce a clear, rational answer to the pure case may help us to develop and organize our thoughts about the issues involved in the myriad, real world transactions in which corporate voting power is shifted. Such an analysis may enable us to anticipate the benefits and dangers created by transfers of voting power in the most common transactional patterns and to assess the different ways in which legal rules can magnify the benefits and limit the dangers.

Before analyzing the arguments for legitimating, rejecting, or

Credit Co., 22 Del. Ch. 74, 194 A. 19 (1937) (deposit of preferred stock to be voted with regard to appointment of directors); Brady v. Bean, 221 Ill. App. 279 (1921) (agreement by shareholder to vote in favor of sale of corporation's assets in exchange for fraction of proceeds which creditor would receive from the sale); Stott v. Stott, 258 Mich. 547, 242 N.W. 747 (1932) (agreement by shareholder to vote in favor of corporate loan in exchange for cancellation of personal debt). Several of the decisions, such as Brady, seem to be based in part on the perception of a serious conflict of interest.

regulating the major forms of vote buying, we should first achieve an understanding of the real functions of shareholder voting rights. This can best be done by examining the basic economic problems that afflict any system of shareholder democracy in an advanced economy and the legal devices that have evolved to mitigate these problems. Part I of this article discusses these problems and partial solutions to them. Part II focuses more directly on the proper legal rules to govern vote buying.

I. PRELUDE: ECONOMIC OBSTACLES TO EFFECTIVE SHAREHOLDER DEMOCRACY AND THE LEGAL PALLIATIVES

Whenever shareholders of a publicly held company vote upon matters affecting the corporation, they engage in a collective action that suffers from many systemic difficulties. Such difficulties include "rational apathy" of shareholders, the temptation of individual shareholders to take a "free ride," and unfairness to certain shareholders even where collective action is successful. Since these three problems are distinct, one should not assume that the same legal inventions will help to solve all of them.

A. The Rational Apathy Situation

Often the aggregate cost to shareholders of informing themselves of potential corporate actions, independently assessing the wisdom of such actions, and casting their votes will greatly exceed the expected or actual benefits garnered from informed voting. Recognition of this phenomenon undoubtedly accounts for several existing legal rules that generally entrust corporate management or the board of directors with all ordinary business decisions without shareholder participation. But the same problem still...
exists with respect to the major subjects of shareholder voting—the election of directors and the approval or rejection of major organic changes such as mergers and liquidations.\textsuperscript{17}

Consider a simplified case. Corporation $X$, with one million voting common shares outstanding, has ten thousand shareholders, each of whom owns one block of one hundred shares. The directors propose a plan to merge $X$ into Corporation $Y$, which would result in the acquisition by the former $X$ shareholders, in exchange for their $X$ shares, of voting common shares in $Y$ with a total market value of $50$ million. In fact, $Y$ would be willing to exchange $60$ million worth of its shares if it had not agreed, under prodding by $X$'s management and in return for its cooperation in recommending the merger, to give extraordinary salary increases to those officers of $X$ who would continue their employment after the merger. Payments would also be made to departing $X$ officers under so-called consulting and noncompetition agreements. Moreover, a majority of $X$'s directors are not officers and would seek a new merger agreement at a much higher price if the current proposal were not approved by the shareholders.

Assume that all of this information is contained in a 240-page proxy statement that is sent to $X$'s shareholders and that any rational shareholder who reads it would decide against the merger. Assume further that if the merger proposal were disapproved, a new one would be adopted which would yield $X$'s shareholders the additional $10$ million gain which Corporation $Y$ was prepared to pay. Thus, the actual benefit to be derived from collective shareholder action against the merger plan would be $1,000 per shareholder. Shareholders do not expect, however, to discover a reason for concluding that disapproval will avert a corporate harm or open the door to a larger corporate gain every time they read a proxy statement. Therefore, assume that they rather optimistically, but rationally, assess the probabilities of such an occurrence, and consequently assign an expected benefit of $50$ per shareholder to collective action of the sort described, that is, action based on each shareholder's reading the proxy statement, making up his mind, and voting. If the average cost of informed shareholder action were simply the opportunity cost\textsuperscript{18} of reading

\textsuperscript{17} E.g., \textit{id.} § 34 (directors must be elected by shareholders); \textit{id.} § 73 (majority vote required to approve plan of merger); \textit{id.} § 84 (majority vote required to approve plan of dissolution).

\textsuperscript{18} The cost attributable to doing one thing to the exclusion of another stems from
the proxy statement before sending in the proxy card, say $120 per shareholder (six hours of reading at $20 per hour—a very low estimate), then the total cost of collective action would be high—$1.2 million. This cost would still be less than the actual benefit to be gained from collective action by informed voters. The cost of such collective action, however, greatly exceeds the expected benefit—$120 versus $50 per shareholder—so that sensible shareholders will not read the proxy statement. They will be rationally apathetic. At the same time, management will be shielded from shareholder policing of their fiduciary duties, thereby allowing them to receive compensation that is unnecessary to induce their services.

Consider now some legal rules that at first blush seem to result in effective shareholder control despite this apathy. The law generally allows a shareholder who is not aligned with management to solicit proxies in opposition to management from his fellow shareholders. A single shareholder of \( X \) might expend $120 in reading the proxy statement and discovering a reason to disapprove the merger plan, and $50,000 in conducting a (very economical) proxy solicitation that would reduce the opportunity cost of investigation by other shareholders to an amount that would induce collective action. Just reading the first few sentences of a countersolicitation, for example, might lead the solicited shareholder to revise upward the expected benefit of reading further, while the body of the counterstatement might greatly reduce the total time and cost that the shareholder spends on reading, since the points to consider would be highlighted. The undesirable merger proposal would then be disapproved, and the shareholders would gain $1,000 per block less whatever opportunity costs they actually incur.

This scenario will not occur, however, if the guardian shareholder cannot recover his $50,120 in costs, for that figure greatly exceeds his own actual and expected benefits. In some jurisdictions, it appears that successful insurgents in a proxy contest may recover their expenses from the corporation if certain requirements are met, but this rule apparently has been applied only in

opportunities sacrificed to pursue the chosen course. This sacrifice is called "opportunity cost." See P. Samuelson, Economics 449 (8th ed. 1973).

20. Id. at 541-44.
21. Successful insurgents may be reimbursed from corporate funds for expenses incurred in a proxy fight, provided (1) reimbursement is ratified by a majority of the share-
cases in which the insurgents succeeded in electing a controlling majority of the directors. This restriction on reimbursement occurs because the corporation is not generally obligated to make reimbursement. Moreover, even if the insurgent who successfully caused a proposed organic corporate change to be defeated or approved were regularly reimbursed for all his expenses, as of right, the guardian shareholder still would not be induced to take action. This is because he does not know ex ante whether investigating any particular proposed corporate action will pay off. Therefore, in order to induce guardian behavior, the guardian shareholder must be compensated for the risk of engaging in such behavior. Conceivably, he could be paid some multiple of his actual expenses in a successful case of insurgency with the multiple being based on the frequency of successful investigation.

For several reasons, it is virtually impossible to implement this procedure in an ideal way, or even in a very satisfactory way, and awareness of this fact may discourage policymakers from allowing the insurgent shareholder to receive risk-adjusted reimbursement. Ascertaining a frequency figure would depend on whether or not particular activities were classified as "investigations"—a determination which would engender tremendous definitional problems. If the frequency were based on past investigations of a particular corporation, an adequate sample of data might not be available. If it involved investigations of all public corporations, or some class of corporations, the figure might be considered unfair by managers and shareholders who believe their company to be more amenable to successful collective action than the average corporation. Moreover, payment of a multiple of actual expenses might result in inefficient and aimless investigation. This procedure, like any cost-based system of reimbursement, would encourage extravagant spending—a problem that would be greatly magnified by a system that in effect reimburses the investigators for the cost of all

holders, (2) the contest is for corporate policy control rather than personal control, and (3) the expenses were reasonable both in nature and amount. Steinberg v. Adams, 90 F. Supp. 604, 607–08 (S.D.N.Y. 1950); Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 173, 128 N.E.2d 291, 293, 148 N.Y.S. 168, 173 (1955), both discussed in E. Aranow & H. Einhorn, supra note 7, at 569–74.


their investigations. But, if each guardian shareholder were paid on the basis of a fixed fee schedule and a legally mandated multiplier, other difficulties would ensue. For example, there would be a tendency to make the multiplier a simple reflection of the average success ratio of investigations. If the multiplier were stipulated and kept from rising by regulators, it would tend to be arbitrary, since regulators have no practical way of finding the optimal figure. In summary, the shareholder-sponsored proxy contest is not an adequate solution to the rational apathy problem.

B. The Free Rider Problem

Another legal approach toward improving the efficiency of collective action is to make it cheaper for each shareholder to act in an informed way. Suppose that in our example the opportunity cost of reading the proxy statement concerning the proposed merger were only $10 per shareholder, because the Securities and Exchange Commission had devised a system of proxy rules that produced extremely concise, quickly understandable proxy statements that emphasize crucial data. Suppose that the Commission also monitors the statement and requires that the crucial information appear in bold face type. The expected benefit of collective action by informed voting is still $50 per shareholder, but the cost of such action is now only $10 per shareholder. The net expected benefit is therefore $40 per shareholder. Yet the desired collective action still may not occur.

Any one shareholder may realize that only fifty percent of the shareholders are needed to block the merger. If the shareholder believes that enough other shareholders will respond to the incentive of the $40 net expected benefit and will act accordingly to produce the desirable collective result, he might decide to save himself the cost of reading the streamlined proxy statement. He can still participate in any benefits of collective action obtained by the other shareholders.

Under this assumption, the net expected benefit of the shareholder's action as a "free rider" would be $50 rather than $40. Yet it may also occur to him that if all the shareholders thought similarly, no collective action would be taken, and everyone would lose the chance of reaping the benefits. The temptation to achieve an individual gain superior to everyone else's may jeopardize the

24. See E. Aranow & H. Einhorn, supra note 7, at 179-82.
25. Id. at 180-81.
attainment of collective benefits. The situation is like the prisoner's dilemma of game theory\textsuperscript{26} and may call for solutions similar in strategy to those that would solve that dilemma.

One might try to solve the free rider problem by having the corporation reimburse each shareholder who incurs reasonable investigative costs with respect to a proposed corporate action. This procedure would spread the costs of collective action among all the shareholders in accordance with their pro rata interest in the company. It would be impractical, however, since the transactional costs of processing reimbursements would be prohibitive, and adequate verification of the shareholders' investigative efforts would be virtually impossible.

As in the rational apathy situation, a shareholder-sponsored proxy contest is at least a theoretically possible approach to the problem. The would-be free riders would probably read at least the first few lines of any purported countersolicitation. Assuming that the guardian shareholder is reimbursed for his expenses, he would be willing to incur the investigative costs necessary to solicit a sufficient number of proxies. But the problem again arises that a suboptimal number of proxy contests will be waged unless the initiators are compensated for the risk of losing some of their struggles, a condition which legal policymakers seem unwilling to satisfy.\textsuperscript{27}

\textbf{C. The Fairness Problem}

Let us again alter the hypothetical so that the free rider problem, like the rational apathy problem, effectively disappears. Suppose that one shareholder, $A$, owns 200,000 shares, while every other shareholder owns only one block of 100 shares. The other facts remain the same. The expected benefit to $A$ is now $100,000, which is likely to be more than the expected cost of reading the proxy statement ($120) and waging an economical but successful proxy contest ($50,000). Unless it deeply galls $A$ to think that he will be treated unfairly, he will take action to achieve the collective benefit even though he cannot be adequately reimbursed for the costs and risks of such action.\textsuperscript{28} Acting strictly for his own benefit, he will nevertheless have created a collective good for all.


\textsuperscript{27} See text accompanying notes 16–23 supra.

\textsuperscript{28} We can assume that $A$ will not be a free rider since his particular expected benefit is high, and he, therefore, would presumably not risk depending on action by other shareholders.
the other shareholders in the company. The smaller shareholders will get the benefit of his concern without bearing a pro rata share of the cost. This phenomenon is an example of what one economist calls the systematic exploitation of the large by the small.29

The problem is one of fairness to the guardian shareholder. Less obviously, problems of allocative efficiency may also arise. The prospect of being taken advantage of by the smaller shareholders may deter investors from becoming dominant shareholders in the first place. The problem once again resembles the prisoners' dilemma, but in this situation the players are all investors as they contemplate buying into any publicly held corporation. But in the real world there are many factors which tempt investors to obtain large percentage interests in companies, not the least of which is the chance of acquiring the various special benefits of controlling the corporation on an ongoing basis.30 Any force toward misallocation created by the phenomenon of exploitation of the large by the small is likely to be more than offset by these other factors. Thus, the only real problem will be unfair treatment of the large, but not controlling, shareholder who undertakes a proxy contest or similar action for the corporation's benefit. As in the previous hypotheticals, legal rules providing for reimbursement of proxy contest expenditures may alleviate the problem, but are not likely to deal adequately with the problem of compensating active shareholders for the risks they bear.

D. General Solutions to the Collective Action Problems

Legal rules have been crucial in the creation of two powerful devices for overcoming the problem of rational apathy and the other barriers to effective and fair collective action. These devices are the shareholders' derivative suit and the corporate takeover. The first does not depend at all on the transferability of shares, or on the fact that common shares typically have voting power; the second device does.

The derivative suit solves collective action problems in an ingenious way. It allows the burden of taking action on behalf of the collectivity of shareholders to be transferred to the plaintiff's attorney. The plaintiff-shareholder is really a figurehead who has little concern for the costs of the suit since the attorney's compensation is customarily contingent upon success. The system further

29. See M. Olson, Jr., supra note 12, at 35.
30. See text accompanying notes 43–44 infra.
ensures that the successful attorney is compensated both for the immediate costs of litigation and for the risks of taking action because court awards of attorney's fees in derivative actions do allow the risk element to be taken into account. And it automatically spreads the costs among all shareholders who benefit from the successful derivative suit, since the plaintiff's attorney is generally paid out of the benefit conferred by the suit upon the corporation.

Consider any of the three variations of our hypothetical. An enterprising plaintiff's attorney might assess the expected benefit to Corporation X of his reading the proxy statement and making related investigations at $500,000 or more. If he were successful in a suit after the merger against the officers of X alleging that they were taking part of the merger price as a bribe, he might recover risk-adjusted compensation for all his costs, provided that they did not exceed the limit for contingency fees. Prospectively, he might contemplate an expenditure of time and effort that, billed at a rate reflecting a normal risk of failure, would yield himself $150,000. As his investigation proceeded and new facts emerged, this estimate would of course be revised—in our example, sharply upward. The amount of upward revision would depend on the details of the particular case. While the cost of a derivative suit is not always less than the cost of a proxy contest, it is often the cheaper or more feasible alternative.

The derivative suit solves collective action problems by making it possible for any shareholder, acting unilaterally, to authorize an agent to seek a collective benefit and to be compensated by all

31. To be sure, this procedure is subject to difficulties similar to those that would plague risk-adjusted reimbursement of insurgent shareholders who lead proxy contests. The special dispensation to shareholder suits may simply reflect the courts' belief that judicial scrutiny of managerial actions yields better outcomes than the reactions of public shareholders subjected to propaganda campaigns, or it may be an historical "accident," i.e., a fact that is hard to rationalize.

For factors sometime considered in awarding fees to a successful plaintiff's attorney in a derivative suit, see Angoff v. Goldfine, 270 F.2d 185, 188-89 (1st Cir. 1959); Newmark v. RKO General, Inc., 332 F. Supp. 161, 163-64 (S.D.N.Y. 1971). See also Cole, Counsel Fees in Stockholders' Derivative and Class Actions—Hornstein Revisited, 6 U. RICH. L. REV. 259 (1972).


33. He might assess the expected benefit as being substantially below this amount. While shareholders may take remedial action, such as voting for new, more competent directors, the recovery in a derivative suit would be the loss of anticipated profits resulting from the directors' misbehavior, an amount which is often difficult to prove.

34. This limit typically is set at 30% of the recovery. See Cole, supra note 31, at 283-85.
shareholders if he succeeds. The corporate takeover, on the other hand, solves collective action problems by making it possible for any person, whether or not an existing shareholder, to become the principal part of the collectivity of interests whose welfare the corporation is designed to serve. A person establishes this status by acquiring a majority of the corporation’s voting shares. Consider one who, in our example, foresees an expected benefit to Corporation X of $500,000, to be gained from investigating a proposed merger and pursuing a desirable course of collective action. After conducting a minimal investigation and discovering that the company is really worth $60 million, he might attempt to capture part of the potential benefit to X by buying as many of its shares as he can at the lowest available price.

For the takeover to succeed and be a socially useful mechanism, there must be voting rights, they must be susceptible to being bought and sold, and their purchaser must be able to obtain a reward for having expended funds to obtain control. The value of the takeover does not depend, however, on whether the voting rights are ever exercised by the shareholders in ordinary times. If the corporate takeover is of great value in solving collective action problems, and if no better solution exists which renders it unnecessary, then it need not bother us that shareholders are generally apathetic about voting, or that most shareholder votes are mere expressions of confidence in management. Nor is it of any great concern that the voting system creates costs because companies must comply with the associated disclosure requirements and proxy rules.\textsuperscript{35}

Yet the great expense of maintaining a voting system—a system justified primarily by the relatively rare transfers of corporate power it makes possible—and the realization that not all corporate takeovers are for the better leads one to ask whether the derivative suit alone is an adequate device for overcoming barriers to collective action. Why not complete the process of separating ownership and control by making all shares nonvoting, or by removing obstacles, such as stock exchange rules,\textsuperscript{36} to the use of


\textsuperscript{36} E.g., New York Stock Exchange, Inc., Company Manual § A15, at A–280 (policy of refusing to list the shares of a corporation which has nonvoting common stock outstanding). Similar policies are expressed in the Public Utility Holding Company Act of
nonvoting shares? Why not allow managements to elect their own successors, as is done in many charitable corporations? Why not trust litigation, including class actions and SEC proceedings as well as derivative suits, to ensure managerial accountability?

The primary reason that the derivative suit and the takeover mechanism are both desirable as remedies for the failure of corporate fiduciaries to maximize the welfare of their beneficiaries is that the strengths inherent in each tend to compensate for the weaknesses of the other. Derivative suits deal well with cases of managerial fraud, self-dealing, and other misconduct, and in some situations have a strong relative advantage. A takeover, on the other hand, may be prompted by any sag in the ratio of a firm's market value to its potential value, whether caused by continuing misconduct, by managerial incompetence or negligence, or simply by the fact that some outsiders are so positioned that they can take the firm in new directions to a higher value. Even an honest, capable, and hard-working management may sometimes find its firm the subject of a takeover attempt that would produce net social benefits if it succeeded.

Though derivative suits result in hundreds of reported cases each decade, it is difficult to find any that resulted in judgments against the defendants based on simple negligence, uncomplicated by fraud or self-dealing. The reason for this lies in the most fundamental postulate of the modern publicly held corporation: business decisions must be made by managers and not by shareholders. It is time consuming and expensive for any individual decisionmaker to gather the relevant information and engage in the analytical process necessary to make a significant business decision. With less centralization of management, shareholders would waste intolerable amounts of time replicating the experiences of corporate officers or would succumb to the rational apathy and free rider problems. With greater centralization of management, the assertion of any individual shareholder that he knows better than the managers how to run the company borders


on hubris. The law essentially tells him that if he feels that way, he should try to become a key manager—either by being hired as an officer or being elected as a director, or by taking control of the company. He has no right to a court order that countermands a management decision, even if he could somehow demonstrate that his business acumen was superior to that of management. Thus, only where the managers are not really acting as managers, that is, as fiduciaries using other people's money in a business, but in their own self-interest, does the law allow the shareholder to challenge managerial conduct.

These considerations explain why the law requires that before a derivative suit can be maintained the shareholder must demand that the directors take action about the alleged wrong. They also explain the difficulty he faces in proceeding with the suit unless he can allege convincingly that the directors participated in the alleged wrong or cannot be trusted to act on the matter in a disinterested manner. Nevertheless, the derivative suit often surpasses other mechanisms for dealing with managerial misconduct. It can be aimed at specific past instances of misconduct and can produce a recovery for the corporation that exceeds the costs of the suit. By contrast, the enormous amount of investment capital required for a successful tender offer may cause substantial financing problems for the aggrieved shareholder. Furthermore, the transactional costs of a takeover may be great enough to render the entire process counterproductive. Moreover, taking control of the company may enable the purchaser to halt managerial theft and self-dealing, but it will not automatically effect recovery of past misappropriations. Consequently, the prospect of being taken over does not deter managers from engaging in large, "one-shot" raids on the corporate treasury. In other words, market controls discipline managers only in the case of repeated or continuing wrongs, whereas legal controls can respond to singular wrongs.38

The first part of this article has argued that the traditional

38. In this context, "controls" mean practices that guide one's behavior toward a social norm, such as honesty or efficiency. "Market controls" influence those who voluntarily enter into commercial transactions. For example, it is a generally held norm that individuals should repay money lent to them. Persons who default on their promises to repay may find it difficult to obtain credit on favorable terms in the future. Because many people will observe this consequence of default and consider its relevance to themselves, the rate of default may be lower than it would be if it were always possible to get new loans on the same terms as anyone else, regardless of one's credit record. In this terminology, the difference between the rate of default between the real and hypothetical state of affairs would be described as due to market controls because managers tempted to run their companies in a
proxy contest is an ineffective method of collective action and that
the corporate takeover is a necessary device for staving off pro-
spective wrongs, and therefore must exist in addition to the deriv-
ative suit as a means for ensuring managerial accountability.
Since the takeover depends upon the transferability of voting
rights, some form of vote buying—as opposed to the acquisition of
proxies by sheer education, argument, and persuasion—is neces-
sary to overcome rational shareholder apathy and the free rider
obstacle to fair and effective collective action.

II. THE ARGUMENTS CONCERNING VOTE BUYING

A. The Categories of Vote Buying

Before discussing the basic arguments for and against vote
buying, one must distinguish several situations in which corporate
voting rights might be bought. There are four fundamentally dif-
ferent kinds of vote buying.

(1) Standard share buying. A person who acquires voting
rights by purchasing voting common shares in a corporation that
has no other common shares with lesser or greater voting rights
per share engages in “standard share buying.” An example is the
purchase of any number of voting common shares in a corpora-
tion that has only one class of common shares. Such a purchase
may or may not give the purchaser control of the corporation. If it
does, the transaction is likely to be subject to special rules,39 but it
can hardly be objectionable simply because votes are being
bought. Standard share buying is generally considered legitimate
by everyone except those who are against letting shareholders
have any voting rights at all.

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quirements regarding any tender offer which would result in the offeror’s ownership of
more than 5% of a class of equity securities registered under the Securities Exchange Act of
(1976) (disclosure of the same information as § 14(d)(1), but not until as late as 10 days
after a party has acquired, by any means, more than 5% of a class of registered equity
securities).
(2) **Equity-centered vote buying.** A purchaser may acquire voting rights that are disproportionate to his share of the equity interest in the corporation, that is, disproportionate to his right to the corporation's residual earnings, yet his chief interest in acquiring voting rights may be the protection of his equity interest. The equity interest may be preexisting or it may be acquired in the same transaction in which the voting rights are acquired. An example of the former situation is embodied by the hypothetical which introduces this article: a three percent shareholder wants to buy proxies from the other shareholders in order to elect directors who will act in the interest of the three percent shareholder *in his status as equity claimant*. An example of the latter situation is the purchase of voting common shares in a corporation which also has a significant number of nonvoting common shares outstanding, or some other class of common shares which have lesser voting rights per share.

Equity-centered vote buying of the second variety is clearly disfavored. For example, the New York Stock Exchange generally refuses to list nonvoting common stock, and supports the notion that shareholder voting rights should bear a reasonable relationship to the actual underlying equity interest the shareholder possesses.\(^40\) In effect, this verges on a presumption that standard share buying is the only legitimate kind of vote buying. Yet there are legal rules that accommodate some equity-centered vote buying of the second type. As an obvious example, state corporation laws generally do allow nonvoting common stock to be issued.\(^41\) Various corporate devices also exist which skew the relationship between equity interest and voting rights, including noncumulative voting and staggered elections of directors; pyramiding, or the leveraging of voting rights by the use of a series of holding companies; and classes of stock with equal voting rights per share but vastly different par values and sales prices.

Equity-centered vote buying of the first type, for example, the purchase of proxies, seems to be outlawed by most state statutes and disallowed by judicial opinions that have dealt with vote buying cases.\(^42\)

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40. *New York Stock Exchange, Inc., Company Manual* § A15, at A–281 (allocation of voting power to classes of stock other than common stock normally should be in reasonable relationship to the equity interests of such other classes).

41. See, e.g., MBCA § 15.

42. See Note, *Shareholder Vote Buying—A Rebuttable Presumption of Illegality*, 1968 Wisc. L. Rev. 927. The commentator argues that although the cases are usually cited as
(3) Special interest vote buying. A purchaser may acquire voting rights for the principal purpose, or with the principal effect, of improving his ability to maintain or develop a non-shareholder business relationship with the company. The non-shareholder relationship with the company may be that of a supplier, creditor, employee, customer, tax collector, or regulatory agency. This "special interest vote buying" frequently involves equity-centered vote buying or standard share buying as well. For example, a shareholder might buy proxies in order to elect directors who will hire him as the company's chief executive officer. A holding company of a firm's major supplier might buy a controlling block of its voting stock in order to control the directorial make-up of the firm and consequently assure the continuation of the business relationship. Or, a consortium of customers may engage in standard share buying to acquire control of the company, with the principal purpose of benefitting their non-shareholder interest in the firm's output. In these mixed situations, it is crucial to determine whether the element of special interest vote buying is significant or paramount, since this kind of vote buying usually raises grave questions of fairness toward the nonselling shareholders.

Finally, the purchaser engaging in special interest vote buying theoretically might not have previously possessed nor even obtained a formal equity interest in the company. Conceivably, someone will some day propose that government agencies such as the Internal Revenue Service should be allowed to purchase a position on the board of directors of a corporation, with or without acquiring an equity interest, in order to influence the corporation to conform to the agency's rules and policies.

(4) Pure vote buying. A purchaser might also acquire voting rights for the principal purpose, or with the principal effect, of improving his ability to affect corporate decisions that could help or hinder attainment of goals he considers desirable, even though he has no equity interest in nor a non-shareholder business relationship with the company. A simple example of this type of purchaser is the activist who buys only a few shares in order to gain standing to wage a proxy contest over an issue of corporate social responsibility. A more intriguing case, requiring an especially in-

establishing a flat rule against vote selling, a rebuttable presumption actually appears to be emerging. See also note supra.

trepid activist, is the attempt to buy proxies to influence or control the vote on an issue of social responsibility. Though existing judicial opinions concerning vote buying may seem to cover pure vote buying, strong arguments can be made that all such precedents are distinguishable.

B. The Benefits and Dangers

(1) A more potent displacement mechanism. The main virtue of vote buying in general is that it facilitates the displacement of incumbent management either for all purposes, or for the purpose of making particular corporate decisions. Thus, vote buying may help to ensure that management will be cognizant of its fiduciary duty to the shareholders and perhaps, depending on the type of vote buying involved, aware of its social responsibilities. As outlined in Part I, some form of vote buying is important in overcoming rational shareholder apathy and the free-rider problem.44 That standard share buying is generally blessed as legitimate reflects widespread intuitive acceptance of this point; the buying of votes as well as residual claims simply cannot be justified by the vague notion that "shareholder democracy" is an ideal.

The question now arises whether all types of vote buying, by offering a threat of displacement, actually facilitate the control of managerial discretion in socially desirable ways. If so, they should be presumed to be legitimate unless countervailing dangers are identified. If not, they should be outlawed without further inquiry.

The answer depends upon one's perception of the proper goals of a publicly held business corporation. Traditionally, the sole, legally recognized goal of corporate management has been to maximize the wealth of the shareholders, within the constraint that management must honor all legal rules governing its dealings with other groups affected by the corporation, such as creditors, customers, taxing authorities, and persons living in the corporation's environment.45 Within this model, which contemporary legal doctrine has not yet expressly eroded, standard share buying and equity-centered vote buying appear useful per se, but may be

44. See text accompanying notes 12–39 supra.
45. For example, customers are protected by the Uniform Commercial Code, the Consumer Products Safety Act, products liability rules, credit disclosure and fair billing laws, and the antitrust laws; creditor safeguards include contract law, the law of mortgages and secured transactions, state-authorized creditor remedies, the Bankruptcy Act, and the law of fraudulent conveyances.
detrimental if they are tainted with elements of special interest vote buying or pure vote buying.

Nonetheless, special interest vote buying and pure vote buying are not always detrimental. For example, a supplier might want to buy voting control of a customer company in order to oust an incorrigibly misguided management and cause the company to purchase goods from the supplier at a fair price. Both the supplier and the customer company could conceivably profit more than if they had each obtained the best available arm's length deal with other parties. Similarly, a pure vote buyer might seize voting control of a corporation and cause it to take a socially responsible action which the former, obdurate management refused to do, and which, as an incidental result, would increase corporate profits. Unfortunately, common sense suggests that such outcomes would flourish less in reality than in the rhetoric of corporate displacers. As a precaution, one might outlaw vote buying by persons who do not have or will not have acquired an equity interest in the corporation. Of course, this rule by itself will hinder but will not preclude those who intend to divert the corporation from its profit maximizing goal toward other ends. The individual intent on looting a corporation, for example, can buy the minimal number of shares needed to control it and then proceed to extract an excessive salary or engage the corporation in unfair dealings with his wholly-owned business. This possibility requires a different set of rules.

Conceivably, the existing legal framework may change in such a way that a corporation would clearly be permitted to take action that is adjudged by the directors, or perhaps directly by a majority of the shareholders, to serve a broader social interest, even though it might require a sacrifice in the potential market value of the company's shares. Within such a framework, pure vote buying might be quite useful, even when the buyer obtains no equity interest, provided that the intent of the scheme is disclosed to the selling shareholders. Under such a set of ground rules, only special interest vote buying would remain deeply suspect.

The most interesting alternative legal framework is probably the least likely to be adopted. The law could require management to obey certain legal constraints in its dealings with groups affected by the corporation, and yet allow any possessor of voting control to cause the corporation to maximize his own interests. Simple voting rights, not attached to any explicit equity interest, would be embodied in separate certificates which could be
purchased by anyone who desires to obtain a share of the control of the corporation. Within this system, for example, a labor union representing the corporation’s production employees might legitimately attempt to buy a majority of the voting certificates in order to accommodate rank and file interests in labor negotiations. Any other group, including the shareholders, would be free to vie for the same voting certificates. Obviously, any type of vote buying would be proper within this system, although it might be subject to special disclosure requirements and to rules designed to eliminate specific dangers and abuses that prove to be characteristic of pure voting certificates. It is not clear that this mythical system would work very well; in any event, it seems a rather remote possibility.

(2) An aid to looters. Consider now, within the traditional model, the chief dangers of vote buying. First, some vote buying is the first stage in a process which leads to unfair self dealing by those who gain control. Second, vote selling may constitute a breach of the selling shareholder’s duty to act in the interest of the corporation as a whole rather than in his own particular interest.

An example of the first danger is provided by the outsider who wants to buy a control block of stock at a premium over the current market price of smaller blocks of the company’s shares, yet does not want to extend his offer to other shareholders because he intends to get a disproportionate return from his investment after obtaining control. After buying 51 per cent of the common stock at a control premium of $51,000, the individual may have himself elected president and paid a salary excessive in the amount (discounted to present value) of $100,000, the maximum he thought he could be paid without provoking a derivative suit. If he had purchased 100 per cent of the stock at the same per share price paid for the control block, his total premium over market would be the same as the unfair advantage he hoped to gain, and there would be no special point to the acquisition. His unwillingness to pay a control premium to every existing shareholder thus reflects a desire to maximize future illicit gains. The same would be true if he had hoped to steal outright from the corporation, or to make it enter into unfair transactions with a business wholly owned by himself.

If we define “looter” broadly to mean any person who intends to enter into an unfairly advantageous relationship of any kind with the corporation, then we can formulate a simple rule of ac-
tion for looters: when you plan to loot the controlled company, buy only the minimum equity interest needed to obtain control, for the more you own, the more you will simply be looting from yourself.

On the other hand, a person who wants to obtain control in order to cause the corporation to do something—for example, expand into a new line of business—which will increase its value, normally will not object to having to buy all the company's shares, as long as he has the funds or financing to do so. He will not even be deterred by having to pay the same price (and thus, premium) to all shareholders. If he thinks he can run the company more efficiently and increase its earnings available for dividends by $100,000, he will realize that each additional share he buys at a given price will entitle him to an equal legitimate share in this future value, and each such purchase will thus yield the same rate of return, which by his own hypothesis will be an unusually generous one.

The difference between these two situations is one of the reasons for the "equal opportunity rule" that has been proposed to govern the sale of control blocks of stock, viz., the offeror need not offer to buy all the company's stock, but he must offer to buy a pro rata amount from each existing shareholder at the same price.\textsuperscript{46} If in practice this would commonly force the purchaser to acquire all of the company's outstanding shares because the holder of a control block generally wishes to sell either all of his stock or none, then only a potential looter would be discouraged and not the entrepreneurial purchaser who can profit from acquiring any additional shares.\textsuperscript{47} Such a rule, which has not been adopted by the courts,\textsuperscript{48} and other doctrines governing the sale of control\textsuperscript{49} are partially attempts to deal with standard share buying that is also special interest vote buying and may lead to unfairness to the corporation and its shareholders. (Actually, standard share buying, which is what it seems to be, may also lead to unfair transactions with the controlling shareholder\textit{as such}; for example, the buyer of a control block may cause the corporation to repurchase some of


\textsuperscript{47} \textit{Id.} at 517-19.


his shares at an unfairly excessive price.) These rules certainly do not attempt to bar purchases of voting control outright.

When it is apparent equity-centered vote buying that may be disguised special interest vote buying and may lead to unfair transactions, however, the policymaker may be tempted to impose an absolute prohibition. The reason is that the normal risks of looting seem greater. By using Rolls' technique of making a tender offer for proxies, for example, a clever looter could acquire control of a corporation with a dollar investment far smaller than would be necessary to buy a control block of shares, and thus could extract his looting proceeds almost entirely from the equity interests of others. That is, at least theoretically, equity-centered vote buying of this type seems to offer looters the opportunity to obtain a greater illegitimate return than that available to them through standard share buying. The difference also arises whenever there are voting and nonvoting shares and would be magnified by any rule permitting the outright purchase of permanent voting rights without the purchase of a corresponding equity interest. Assuming that this opportunity for additional looting is real, it may stimulate more frequent and more intense efforts by looters to acquire voting control of companies.

One might be tempted to conclude, therefore, that equity-centered vote buying (or a particular variation on that theme, such as the tender offer for proxies) should be categorically forbidden. But there are good reasons to resist that conclusion. First, on some occasions, equity-centered vote buying may be the cheapest or most feasible way for a person sincerely interested in shareholder welfare to achieve results that benefit the corporation as a whole. The Rolls hypothetical50 was designed to demonstrate how this might occur in the context of a tender offer for proxies. One commentator has suggested that the decided vote buying cases indeed reveal an emerging rebuttable presumption that equity-centered vote buying is undesirable unless it can be shown that (1) the shareholders unanimously consent to it; (2) the vote buyer cannot profit more than other shareholders; (3) no harm can befall the corporation; or (4) the agreement will confer a substantial benefit on the corporation.51 An objection can be raised that tender offers for proxies and other types of equity-centered vote buying are only rarely more effective displacement mechanisms

50. See text accompanying notes 1-7 supra.
51. Note, supra note 42, at 929.
than ordinary tender offers. After all, the appeal of the Rolls hypothetical depends on the fact that the Creative Fund faces particular constraints of taxation and regulation. But even if the point about rarity is true, it seems only to argue for a rule placing the burden of showing a good business purpose upon the initiator of the vote buying plan. Moreover, the tender offer for proxies might have wider use as a means of evading state anti-takeover statutes that ought to be evaded.  

Second, the prevalence of looters and the degree to which they will respond to the theoretical advantages of equity-centered vote buying are empirical questions. The extra looting induced by permitting tender offers for proxies might in fact be very small. Though it is true that one who owns fifty-one percent of the common stock of a solvent corporation takes fifty-one cents from himself for every dollar he loots from the corporation, while a controlling person who owns only three percent takes only three cents from himself per dollar looted, the fifty-one percent shareholder does have an incentive to loot. Granted, if the probability of being caught increases as the gross amount of looting proceeds increases, the three percent shareholder may have an incentive to extract an even greater amount than a similarly situated fifty-one percent shareholder because he can expect a greater return for each unit of additional risk that he takes. Whether this consideration is significant in practice depends on a multiplicity of other factors, such as the particular degree of risk aversion of the individual looters. It is not even clear that the risk of being caught varies as suggested: the three percent shareholder’s risk may be greater because he is beset by a greater number of potential monitors. Moreover, a temptation to loot is presented to corporate officers of huge, publicly held corporations over which they have de facto control but comparatively little stock. Looting occurs, but it is not generally regarded as intolerable.  

Third, any looting that actually follows equity-centered vote buying will violate existing legal rules against embezzlement, fraud, or self-dealing. In both the traditional sale of control cases and the hypothetical involving the tender offer for proxies, one may legitimately ask why the law should focus on the point at which control shifts, and regulate the shifting, rather than deal with the looting itself. After all, self-dealing can occur at any time in a corporation’s life, not just in the wake of a shift of control; the

temptation to loot is presented to anyone other than a sole owner, who has control, regardless of how control was obtained. If the explanation is that the rules against self-dealing—for example, the ubiquitous “fairness” test of transactions between a corporation and its directors—are not very effective, then the proper response is to make these rules stricter or to enforce them more rigorously.

Fourth, effective disclosure laws provide further protection from potential looters. If the tender offeror for proxies fails to disclose his nonshareholder relationship, or fails to disclose his plan or even lies about it, the shareholder might have the alternative remedies of proving that the relationship was unfair or that the offeror violated his disclosure duties. The latter may be less expensive and more easily accomplished.

Fifth, the self-interest of vote sellers will lead them to be prudent about selling their votes. They will not knowingly sell to looters, or possible looters, as long as they continue to hold a portion of the equity interest in the company. Indeed, this fact could potentially chill all but the more clearly desirable tender offers for proxies. To a much lesser extent, it also applies when some stock is to be permanently converted to nonvoting status. Interestingly, this protection does not operate in the conventional sale of control situation, where the controlling person or persons usually sell out their entire interest in the company. In this context, the old controlling group might be unconcerned that they might sell to looters. Yet the law does not prohibit sales of control blocks; it only stipulates that the sellers have a duty to the nonselling shareholders not to sell to persons whom they know or should know intend to loot the company. A fortiori, the law should not flatly prohibit all sales of proxies.

(3) An occasion for fiduciary lapse by shareholders. The second chief danger of vote buying is that it may occasion a breach of fiduciary duty by the vote seller in his capacity as shareholder. In the view of the Restatement of Contracts, for example, it is corrupt for an officer or shareholder of a corporation to take personal consideration for the exercise of his powers of management in a particular way. In the conventional sale of control, the seller may act to maximize his own self-interest by selling voting control

53. Id. at 618–19, 847–50.
54. “A bargain by an official or shareholder of a corporation for a consideration enuring to him personally to exercise or promise to exercise his powers in the management of the corporation in a particular way is illegal.” RESTATEMENT OF CONTRACTS § 569 (1932).
to the bidder who offers the highest price, while at the same time
inviting injury to the corporation by selling to a determined looter.

The seller of control might also collude with the buyer to de-
fraud the other shareholders. In fact, this basic factual pattern, or
something like it, characterizes many of the cases that purport to
outlaw vote buying. Suppose, for example, that Corporation \( X \)
is owned by five shareholders. \( A \) owns sixty percent of the com-
mon shares, while \( B, C, D \) and \( E \) each own ten percent. There
are ten directors, six of whom are \( A \)'s obedient nominees.
Corporation \( Y \) suggests that \( X \) sell its assets to \( Y \) at a price which
\( A \) knows to be $10 million short of what other prospective buyers
would be willing to pay. \( Y \) offers to pay $7 million to \( A \) if he
recommends and votes for the plan and the sale actually occurs.
If the offer is accepted and the deal completed, \( X \) loses $10 million
of potential profit and \( Y \) gains $10 million before payment to \( A \).
\( A \)'s share of the $10 million loss is $6 million, but he receives a
cash payment of $7 million, leaving him a net gain of $1 million.
Corporation \( Y \) has a net gain of $3 million and the minority
shareholders of \( X \) suffer a net loss of $4 million. What has oc-
curred is clearly a form of theft.

In a real and slightly more complicated case, the defendant
agreed to pay the plaintiff to vote for selection of a railroad depot
site near the defendant's land. If the site were chosen, the defend-
ant's land would greatly appreciate in value. The court seemed
unconvinced by testimony that the site was the one most suitable
for the plaintiff's corporation, and the vote selling agreement was
held improper. The case is interesting because, unlike the situation
in the hypothetical just described, what the defendant would
have gained was not necessarily what the corporation would have
lost; indeed, it is conceivable that the best interests of the defend-

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Directors and other officials act in a fiduciary capacity and should exercise
their powers with untrammeled judgment. Therefore a bargain, the tendency of
which is to induce them to consider not simply the advantage of the corporation,
but their own personal advantage distinct from the interest of the corporation is
illegal. So likewise a shareholder is under a similar duty with reference to his
voting powers. The rule stated in the Section has no application, however, to
agreements where the only advantage bargained for is that which may accrue
through the ownership of shares in the corporation.

Id., Comment a.

55. See, e.g., Palmbaum v. Magulsky, 217 Mass. 306, 104 N.E. 746 (1914); Fuller v.
Dame, 35 Mass. (18 Pick.) 472 (1836); Macht v. Merchants Mortgage & Credit Co., 22 Del.
Ch. 74, 194 A. 19 (1937); Dieckmann v. Robyn, 162 Mo. App. 67, 141 S.W. 717 (1911).


57. Id. at 481–82.
ant and the corporation coincided.\textsuperscript{58}

While the possibility that vote sellers may violate a fiduciary duty is a real danger, it does not entail an automatic prohibition of vote selling \textit{per se}. No one has suggested that standard share selling which results in a shift of control should be flatly prohibited because the seller of control may tolerate or even actively cooperate in the buyer's misbehavior. Moreover, the susceptibility of equity-centered vote selling to this danger varies. Where the buyer of proxies acquires them from one or a few controlling shareholders, collusion to defraud the minority shareholders may be quite likely. A relatively heavy burden might be imposed on the vote buyer to prove a reasonable benefit to the corporation. By contrast, it would be enough precaution to insist that the public tender offer for proxies, which presents much less danger of collusion, be made to all shareholders on equal terms, and that if more proxies are tendered than the offeror wishes to buy, he must purchase them pro rata from all of the tendering shareholders.\textsuperscript{59}

C. \textit{Some Possible Analogies and Lesser Arguments}

A corporate lawyer's probable instinct when confronted with the Rolls hypothetical concerning a tender offer for proxies is to think about apparently analogous situations for which there are established rules. While this process may lead to a better understanding of the problems of vote buying and the relationships between various legal rules, it likely will not uncover any fundamental policy considerations other than the three discussed in the preceding section, \textit{viz.}, the benefit of serving as a displacement mechanism, and the dangers of looting by vote buyers and breach of fiduciary duty by vote sellers.

The analogy to the traditional sale of control case has been touched upon at various points above. The tender offer for proxies may be categorized as a sale of control in which the buyer pays only the control premium, and not the price of the shares themselves, as equity investments. This description suggests no new policy arguments.

The particular vote-buying plan in the Rolls hypothetical can

\textsuperscript{58} Perhaps such a benefit should constitute an affirmative defense. \textit{See} text accompanying note 54 \textit{supra}.

be compared to a de facto merger\textsuperscript{60} plan, since its purpose is to elect directors who will cause the company to combine with another. Yet, since a formal merger is contemplated, it seems pointless to apply the rules of the de facto merger doctrine,\textsuperscript{61} such as giving the shareholders appraisal rights\textsuperscript{62} at the time of the vote buying offer.

Buying shareholder votes can also be analogized to paying a director to vote a certain way on an issue. Such a practice is invariably regarded as corrupt.\textsuperscript{63} The issues raised by this analogy were discussed in connection with breach of fiduciary duty of the selling shareholders.\textsuperscript{64} The duties of a director with respect to voting are different from those of a shareholder in that the shareholder can sell his underlying equity interest along with his vote, while the director cannot sell his position as director. But this difference seems only to support the existing rule that automatically prohibits a director from selling his right to vote as a director. It does not aid the development of proper rules governing the purchase of shareholder votes, which, absent collusion, is not necessarily corrupt.

Another obvious analogy is the analogy to voting trusts and voting agreements, which are generally legitimate provided that they comply with the applicable legal restrictions.\textsuperscript{65} If the participants in a voting trust can transfer their voting rights in return for valuable consideration\textsuperscript{66} while retaining the equity interest represented by the shares, does not consistency require that shareholders be able to sell their votes for cash? A distinction based on the type of consideration for giving up one's voting power seems to be without substance. This analogical argument is weak, however. Voting trusts and vote pooling agreements are basically devices created to solve the peculiar and troublesome collective action problems of closely held corporations, such as the difficulty of achieving cooperation and avoiding voting deadlocks. Their ra-

\begin{itemize}
\item \textsuperscript{60} A de facto merger is a transaction (or multiple transactions), usually involving a sale of corporate assets or a stock acquisition or both, which is essentially a merger despite attempts to label it otherwise. Certain incidents characteristic of statutory mergers are, therefore, applied to it. \textit{See} D. Herwitz, \textit{Business Planning} 698 (1966).
\item \textsuperscript{61} \textit{See generally id.} at 697–723.
\item \textsuperscript{62} \textit{See} MBCA §§ 73–74.
\item \textsuperscript{63} \textit{See} note 57 \textit{supra} and accompanying text.
\item \textsuperscript{64} \textit{See} text accompanying notes 57–62 \textit{supra}.
\item \textsuperscript{65} \textit{See} MBCA § 32.
\item \textsuperscript{66} The consideration is the transfer by others of their voting rights to the same trust on specific terms with respect to a voting agreement; the consideration for each participating shareholder is the other participants' promises to vote in a certain way.
\end{itemize}
tionale cannot be assumed to justify vote selling in the context of publicly held corporations. One is forced back to the more basic policy considerations discussed above.

One can also draw an analogy between the tender offer for proxies and the conventional tender offer for shares. The argument can be made that the tender offer statutes are aimed not primarily at offers to purchase shares, but at offers that may result in shifts of control and that impose pressures on shareholders or expose them to certain risks;\(^6\) that the tender offer for proxies involves the same pressures and risks; and that the tender offer statutes therefore should be interpreted or amended to cover tender offers for proxies. This logic may be intrinsically correct, but it produces no important recommendations. A tender offeror for proxies might easily comply with the Williams Act.\(^6\) State laws governing vote buying are the real obstacles.\(^6\) Moreover, the wisdom of various features of the takeover laws, regardless of their applicability to the tender offer for proxies, has been continually questioned.

Selling one's vote is also comparable to creating a new class of nonvoting stock without complying with the usual requirements for creating new classes of stock, such as amending the articles of incorporation in accordance with statutory procedures.\(^7\) This is purely a procedural issue that by itself reveals nothing about whether shareholders should be allowed to sell proxies in the first place.

The tender offer for proxies might be further compared to a proxy contest in which the contestants spend funds to entertain shareholders whom they are attempting to solicit. It is not clear whether such expenditures are considered by the courts to be illegitimate \textit{per se}, illegitimate only when excessive, or not illegitimate at all.\(^7\) In any event, insightful judicial reasoning concerning the propriety of such expenditures is not available, so that the analogy to the proxy contest cases is not helpful.

Finally, corporate vote buying can be compared to vote buying

\(^6\) See Note, \textit{The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934}, 86 Harv. L. Rev. 1250, 1270 (1973) (arguing that Williams Act was designed to cover all offers which have a capacity to pressure shareholders into making uninformed, ill-considered decisions on whether to sell their securities, regardless of whether any takeover intent exists).

\(^6\) See note 39 supra.

\(^6\) See note 10 supra.

\(^7\) See MBCA § 55, 54.

\(^7\) See E. Aranow & H. Einhorn, supra note 7, at 595.
in the political arena, where it is clearly improper. But the two contexts are distinguishable in many ways. As in the corporate area, displacement of incumbent politicians by voting citizens is subject to severe rational apathy and free rider problems. Political campaigns, like proxy battles for corporate control, may sometimes help to alleviate these problems, and they certainly occur more frequently. But in the political arena, nothing corresponds to the derivative suit as a way to overcome difficulties of collective action; an individual citizen cannot sue "on behalf of" the polity to remove an incompetent politician or to force him to return embezzled funds. Nor does anything correspond to the conventional corporate takeover. The parallel would be a widespread purchase of citizen "statuses," or bundles of legal duties, tax liabilities, and rights to receive specific governmental benefits and to enjoy public benefits. But citizen status is not saleable, because it is tailored to each citizen's particular characteristics; for example, those with greater ability to pay taxes are generally required to pay a greater proportion of their income.

In view of these relative disadvantages of the political process, one might suggest that the case for political vote buying is even stronger. The answer to such a suggestion, however, is compelling. The rich would have an advantage in election campaigns greater than what they already possess. That the rich have an advantage in corporate takeovers and proxy contests is not much more objectionable than the fact that the rich can buy better television sets. But the rich politician's advantage is an especially suspect phenomenon. For one thing, elected politicians can legitimately influence the distribution of governmental benefits by voting, for example, for a program with a particular redistributive impact. A dutiful corporate director or officer, on the other hand, usually cannot change the extent to which each share of stock can participate in the residual earnings of the enterprise. Furthermore, the possibility that vote buyers will be looters is more serious in the political context, because the protections against political looting are weaker. The candidate seeking election to political office is not subject to any disclosure laws that approximate the federal securities laws in the severity of their affirmative disclosure requirements or, more importantly, in the remedies which they provide for fraud and nondisclosure. There is no citizens' derivative suit to redress any political looting that might occur after vote buying. The self-interest of the vote sellers would provide no protection, for even rampant political looting by the vote buyer
may have little or no impact on the governmental benefits which the vote sellers might expect to obtain, especially if they are in a socioeconomic group that is little affected by current governmental programs. And finally, there is a great danger that vote sellers would breach their duties as citizens by colluding with the buyer, who may tacitly agree to loot only from governmental programs that do not benefit the vote sellers. These dangers are compounded by the fact that the buyer needs to buy only votes among those not otherwise committed to him; he does not have to make the agreement with all his supporters, and may even end up cheating some of them.

Despite all this, it may be thought that there is some merit in allowing political candidates to make public "tender offers" for votes as a device for overcoming rational citizen apathy. A candidate could promise to pay cash to those who vote for him so long as the offer is made available to all citizens eligible to vote in the particular election, all who accept the offer are paid the same amount per vote, and full disclosure is made concerning what the politician plans to do in office. Whatever the worth of this suggestion, the reasons for prohibiting outright vote buying in the political arena do not apply to the corporate context since the corporate and political environments are so significantly different.

Some minor arguments against equity-centered vote buying and some additional general policy considerations remain to be considered. First, it may be said that such vote buying, as exemplified by the tender offer for proxies, offends the notion of shareholder democracy which calls for informed individual decisionmaking and the best possible aggregation of shareholder preferences, not decisions based on side payments. But, as Part I was at pains to indicate, it is vain to expect that shareholders can overcome rational apathy; only an alternative means for collective action can obliterate its effect. In any event, since allowing tender offers for proxies and other forms of vote buying would not increase rational shareholder apathy, prohibiting vote buying would not serve the purpose of one who desires more shareholder participation.

The second minor argument against equity-centered vote buying is based on the notion that if vote buying by insurgents is al-

lowed, fairness requires that the target should also be permitted to buy votes. The objection is that this system would open the way to uncontrolled depletion of corporate assets at the instigation of any determined insurgent. But the premise is wrong: fairness does not require that incumbent managers be able to use the corporate treasury for vote buying. As representatives of the company and guardians of its interest, the incumbent managers have the right to make reasonable proxy contest expenditures for the purpose of informing the shareholders about the company’s affairs, their own performances, and their views about the inadequacies of the insurgent vote buyer and his plans for the company.\textsuperscript{73} As stockholders, the managers may be interested in expending their own money to secure proxies and protect their equity. If they are not willing to match the insurgent’s price for votes, an inference may be drawn that they lack confidence in their ability to run the company in as profitable a manner as the insurgent, or that they possess, as shareholders, a lesser equity interest and therefore are less concerned with the corporation’s future earnings. Neither explanation gives them a claim for protection against the insurgent.

Third, vote buying could conceivably lead to wasteful bidding wars. But like competition among conventional tender offerors, competition among vote buyers would result in the sellers’ obtaining a better price. Since a single proxy cannot be given to more than one of the opposing parties, the parties will not duplicate each other’s payments for proxies. A “war” may lead competing vote buyers to incur greater transaction costs and, if the protections against subsequent looting are strong enough, there will be a natural limit to such expenditures. No vote buyer would be willing to spend more on proxy payments and transaction costs than the amount he expects to gain by his victory. He will also limit his spending to account for the risk of losing the war.

\section*{III. Conclusion}

The purpose of this article is to attack the notion that whenever a person purchases voting rights in a corporation he should also purchase the underlying equity interest. What has been defined as equity-centered vote buying should be generally permitted. Those objecting to such purchases should have the burden of proving that the vote buying in question presents a clear, substantial danger that the corporation or some of its shareholders will be

\textsuperscript{73} See E. Aranow & H. Einhorn, \textit{supra} note 7, at 547-49.
unfairly treated if they wish to have the vote buying offer or agreement declared invalid. The vote buyer should be able to defend himself not only by rebutting the plaintiff’s case, but also by raising and proving the affirmative defense that there is a reasonable basis for believing that the vote buying will facilitate action that will increase the corporation’s value, and that this prospect outweighs any dangers suggested. A stated intention by the defendant that he will not seek to establish a nonshareholder relationship with the corporation other than a directorship should weigh heavily in his favor. Further, the fact that the defendant attempted his vote buying publicly and made his offer available to all shareholders on equal terms should be viewed favorably.

Perhaps the most important aspect of this exercise is the light it casts on the role of corporate voting systems. They are valuable despite the fact that participatory shareholder democracy is comatose and has not responded to repeated attempts at resuscitation. It is a better use of resources to attempt rejuvenation of the techniques by which individual shareholders can be induced to act decisively on behalf of the corporate collectivity. Within this large endeavor, the encouragement of responsible vote buying is a worthy project.