TOWARD A LIABILITY RULE APPROACH TO THE "ONE SHARE, ONE VOTE" CONTROVERSY: AN EPITAPH FOR THE SEC'S RULE 19c-4?

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*While corporate democracy is a pertinent concept, a corporation is not a New England town meeting.*¹

INTRODUCTION

For as long as the corporation has existed as a legally recognized entity, the problem of shareholder voting rights has existed in some way as well.² Like St. Elmo's Fire, though, this ever present problem has flared up only at certain times; times that, moreover, correspond to watershed periods of American history. The 1980s have been one such period, a time during which the intense debate of the 1920s over the "one share, one vote" issue³ has been re-ignited.

Until the 1920s, the American investment custom, with little exception, was one vote for each share of a corporation's common stock.⁴ By the mid-1920s, though, a trend emerged towards the use

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¹ TW Servs., Inc. v. SWT Acquisition Corp., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,180 n.14 (Del. Ch. Mar. 2, 1989) (Allen, C.).

² See, e.g., Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote,"* 56 CORNELL L. REV. 1, 3 (1970) (noting that the "problem of shareholder voting was recognized at the earliest stages of the development of business corporations in England, 400 years ago").

³ As used in this Comment, the term "one share, one vote" refers to a situation in which all common shares of a corporation have equal voting rights. The converse situation is "disparate voting," in which one class of common shares possesses voting power inferior or superior to that of another class of common shares. See Voting Rights Listing Standards—Disenfranchisement Rule, Exchange Act Release Nos. 25,891 and 25,891A, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,247 (July 12, 1988) [hereinafter Release] (Securities and Exchange Commission stating that "departures from the one share, one vote rule are collectively called 'disparate voting rights plans'").

⁴ See, e.g., 1 V. MORAWETZ, *PRIVATE CORPORATIONS* § 476 (2d ed. 1886) (pointing out that "the custom of giving the shareholders . . . a vote for every share has become so well established that it is fair to imply an intention to follow this custom in the absence of any indication to the contrary").

of nonvoting common stock by public companies.⁵ A technical subject traditionally the province of legal scholars and other intellectuals, nonvoting stock quickly attracted the attention of the nation's most powerful men and institutions. The appeals of Professor William Z. Ripley—a political economist at Harvard who had made the ideal of one share, one vote a personal crusade—led President Calvin Coolidge and the Congress to make “threatening noises” about the emerging dual class capital structures.⁶ The Justice Department announced an inquiry into the matter as well,⁷ and the entire issue could be read about on the front page of the New York Times.⁸ Because of this maelstrom, the New York Stock Exchange (NYSE) announced in January, 1926 that as a general matter, it would no longer list disparate voting common shares.⁹ The historic NYSE one share, one vote listing rule remained undisturbed for nearly sixty years.

In many ways, the 1980s proved a replay of the 1920s. Once again, an economic trend toward dual class recapitalizations emerged.¹⁰ In 1984, the NYSE announced that it was putting a moratorium on enforcement of its longstanding general rule of one share, one vote pending further investigation of the rule. Subsequently, amidst a media fanfare reminiscent of the 1920s, the NYSE's directors in July, 1986 approved a resolution allowing the listing of securities created in a dual class transaction provided that the trans-

⁵ See Stevens, *Stockholders' Voting Rights and the Centralization of Voting Control*, 40 Q. J. ECON. 353, 355 (1926).

When a company goes public with a disparate voting capital structure, it is said to have undergone a “dual class capitalization.” A “recapitalization,” however, is a material readjustment in the rights of a corporation's *existing* capital stock. See W. CAREY & M. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 1268 (6th ed. 1988). Hence, when a public company reclassifies its single class of common stock into two new classes with disparate voting rights, the firm is said to have undergone a “dual class recapitalization.”

⁶ See Lowenstein, *Shareholder Voting Rights: A Response to Professor Gilson*, 89 COLUM. L. REV. 979, 982 (1989).

⁷ See Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 695-96 (1986).

⁸ See *President Studies Non-Voting Stocks*, N.Y. Times, Feb. 17, 1926, at 1, col. 5.

⁹ See Lowenstein, *supra* note 6, at 982.

¹⁰ Of the 44 public companies that created a dual class capital structure between 1962 and 1984, for instance, 37 of them—or 84%—did so between January 1980 and January 1985. See Partch, *The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth*, 18 J. FIN. ECON. 313, 314-15 (1987). These firms were for the most part traded on the American Stock Exchange (AMEX) and over-the-counter (OTC) markets, that had no one share, one vote policy comparable to that of the NYSE. See *infra* note 150 for a discussion of the structure of modern recapitalizations.

action was approved by a majority of the company's independent directors and publicly held outside shares.¹¹ Once again, as in the 1920s, threatening noises emanated from Washington.¹² A number of bills, all of them hostile to the Exchange's revisionism, sprang up in Congress soon thereafter.¹³ For the second time this century, scholarly commentary critical of the NYSE's actions and calling for restrictions upon dual class capital structures appeared.¹⁴ The Securities and Exchange Commission—a creature of the New Deal era that did not exist during the previous imbroglio over the one share, one vote issue—stepped into the breach in July, 1988 with the promulgation of Rule 19c-4.¹⁵

In essence, Rule 19c-4 sought to mandate a general one share, one vote rule for America's publicly traded companies and to ban, with few exceptions, dual class recapitalization transactions. Such goals are clearly evidenced by the formidable "effects test" forming the basis of the SEC's rule:

No rule, stated policy, practice, or interpretation of [an] exchange shall permit the listing, or the continuance of listing, of any common stock or other equity security of a domestic issuer, if the issuer of such security issues any class of security, or takes other corporate action, with the *effect of* nullifying, restricting or disparately

¹¹ See 18 Sec. Reg. & L. Rep. (BNA) 998 (1986); *Big Board Ends Equal Voting Rule*, N.Y. Times, July 4, 1986, at D1, col. 1. The NYSE resolution brought the Exchange's listing policy substantially into line with state corporate law standards. The general state law rule has been to permit the creation of disparate voting common stock classes, but to make the matter a mandatory subject of the articles of incorporation. See H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS* § 124, at 290 (3d ed. 1983). Hence, under state law, recapitalizations are permitted provided they are approved by a majority of the firm's directors and shares. The NYSE resolution simply strengthened this approach, requiring majority approval by the firm's *independent* directors and *outside* shares.

¹² See Sommer, *Three Takeover Reform Bills Pending in Congress*, NAT'L L.J., May 23, 1988, at 25 (reporting that "[a]lmost immediately, this proposal [the NYSE resolution] elicited negative responses on Capitol Hill").

¹³ See *id.* at 24-27; *id.*, June 27, 1988, at 1, col. 1.

¹⁴ See, e.g., Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CALIF. L. REV. 1 (1988). The original work embodying the conventional outlook on shareholder voting rights as it originated in the 1920s is Professor Ripley's classic *Main Street and Wall Street*. See W. RIPLEY, *MAIN STREET AND WALL STREET* (1927).

¹⁵ 17 C.F.R. § 240.19c-4 (1989). Rule 19c-4 was promulgated by the SEC under Section 19(c) of the Securities and Exchange Act of 1934, which empowers the Commission to "abrogate, add to and delete from" the rules of exchanges or associations within the jurisdiction of the 1934 Act. See 15 U.S.C. § 78s(c) (1988). Accompanying adoption of Rule 19c-4 by the SEC was a written Release, in which the Commission's position with respect to Rule 19c-4 is elaborated. See Release, *supra* note 3.

reducing the per share voting rights of holders of an outstanding class or classes of common stock of such issuer registered pursuant to Section 12 of the [Securities Exchange] Act [of 1934].¹⁶

Although neither the SEC nor any other commentator so characterized it, a one share, one vote rule such as Rule 19c-4 protects a shareholder's right to vote with a general "inalienability rule" in the lexicon of the now famous Calabresi and Melamed framework.¹⁷ Even if shareholders knowingly and willingly desire a change in the corporation's voting structure, such a transaction would not be permitted. This Comment undertakes to examine critically the mindset and reasoning behind legally mandated shareholder voting equality, and to put forward an alternative model of regulation for dual class recapitalization transactions, using the SEC's Rule 19c-4 as a springboard for the analysis. This Comment argues that the formal conventional rationales underpinning a one share, one vote rule such as Rule 19c-4 are unsatisfying; and that the persuasive reasons that do exist for regulation of dual class capital structures point to a policy prescription significantly different than the inalienability rule approach favored by the SEC and other one share, one vote advocates.

Although Rule 19c-4 itself has been set aside recently on administrative law grounds by the District of Columbia Circuit,¹⁸ several factors strongly suggest the continuing relevance of this Comment's undertaking. First, it is unlikely that the underlying controversy over the *wisdom* of a one share, one vote rule is dead or moot—even if the D.C. Circuit's ruling stands.¹⁹ The SEC, for its part, has hardly lost

¹⁶ 17 C.F.R. § 240.19c-4(a) (1989) (emphasis added). An identical test appears in Rule 19c-4 for any "association." See *id.* § 240.19c-4(b). Hence, Rule 19c-4 by its terms covered not only the NYSE but also the AMEX, the OTC markets, and most regional markets as well.

¹⁷ See Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972). In this seminal work, Calabresi and Melamed develop a framework for analyzing legal disputes—essentially pollution and nuisance problems—in which one party engages in activity imposing damages on another. The right to engage in that activity is an "entitlement," as is the right to be free from that activity. See *id.* at 1090. "Inalienability rule" protection means that the entitlement cannot be taken away from the owner even if he consents to it. See *id.* at 1092-93. "Liability rule" protection means that the entitlement can be taken away from the owner even without his voluntary consent, but the person so doing will have to pay the owner an objectively determined value for the entitlement. See *id.*

¹⁸ See *Business Roundtable v. SEC*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,291, at 96,339 (D.C. Cir. June 12, 1990) (holding that Rule 19c-4 "is in excess of the Commission's authority under § 19 of the Securities Exchange Act of 1934").

¹⁹ As of this writing, the Commission's official position is one of "reviewing the

enthusiasm for the substantive principles behind Rule 19c-4 and the one share, one vote ideal.²⁰ The sentiment in Congress, moreover, for a statutory rule of one share, one vote has been remarkable.²¹ Indeed, the issue of shareholder voting rights has remained a bone of contention among policy makers and commentators for literally centuries,²² and a single administrative law ruling probably will not change 400 years of history. Even absent congressional action, it may be possible for the SEC still to realize the goals of Rule 19c-4 by grounding a one share, one vote rule in Exchange Act provisions other than § 19—a possibility to which the D.C. Circuit alluded in its opinion.²³ While the court could neither address nor supply rationales not invoked by the Commission itself in the litigation, some commentators indeed have argued that the SEC retains ample statutory authority elsewhere upon which to base a one share, one vote rule.²⁴ Taken together, these observations suggest that while the body of Rule 19c-4 may be dead, its soul is likely to linger on among the living.

Second, the philosophy and reasoning behind Rule 19c-4 typify the “state of the art” in a longrunning scholarly advocacy of a one share, one vote rule. Having become the leading spokesman for the shareholder egalitarian movement and the most influential propagator of that movement’s views, the SEC presents itself as the most appropriate object of any critical inquiry. The Commission’s views

decision to determine our further course of action.” Hinden, *Appeals Court Upsets 1-Share, 1-Vote Rule*, Wash. Post, June 13, 1990, at B4, col. 1 (statement of John D. Heine, SEC spokesman).

The deadline for requesting a rehearing *en banc* by the D.C. Circuit has passed, although the Commission could of course appeal the case directly to the Supreme Court.

²⁰ At a press conference following the D.C. Circuit’s ruling, Richard Ketchum, director of the SEC’s Division of Market Regulation, expressed the hope that the stock exchanges themselves would “step up” and adopt a one share, one vote rule as a private listing standard. See *Court Finds SEC Exceeded Authority in Adopting One-Share/One-Vote Rule*, 22 Sec. Reg. & L. Rep. (BNA) 895, 896 (June 15, 1990). Presumably, the Commission would not be disappointed if such a listing standard were to take the same form as Rule 19c-4.

²¹ See *supra* notes 6 & 12-13 and accompanying text. Most prominent among the recently proposed one share, one vote bills are S. 1314 and H.R. 2783, sponsored respectively by Senator Alfonse D’Amato and Representative John Dingell—both influential figures in Congress.

²² See *supra* note 2 and accompanying text.

²³ See *Business Roundtable v. SEC*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 95,291, at 96,346 (D.C. Cir. June 12, 1990).

²⁴ See, e.g., Karmel, *Qualitative Standards for “Qualified Securities”: SEC Regulation of Voting Rights*, 36 CATH. U.L. REV. 809, 826-27, 830 (1987) (pointing to § 14(d)-(e) of the Exchange Act, added in 1968 and commonly referred to as the Williams Act).

on securities regulation are naturally sought out by and surely influence other national policy makers. It is therefore likely that both the form of and the arguments justifying Rule 19c-4 would play a prominent role in any future debate over a one share, one vote rule.

Third, what this Comment argues to be the true basis behind one share, one vote efforts such as Rule 19c-4—an inappropriate moral-political view of the corporation and its shareholders—is a philosophy with implications going beyond the issue of shareholder voting rights. Because this view colors so much of the SEC's regulatory approach in general, a dissection of Rule 19c-4—and an inquiry into alternative regulatory philosophies—provides insights helpful in evaluating the wisdom of the Commission's efforts elsewhere within its regulatory portfolio.

While in one sense perhaps an epitaph for a particular regulation that once was, this Comment more importantly provides a lens with which to peer into, a basis from which to evaluate, and an alternative to a future that at some point is likely to attempt a replay of the past.

Part I contends that the formal utilitarian justifications for a one share, one vote regulation such as Rule 19c-4 are exaggerated relative to the severity of the regulation prescribed. Ironically, some of the problems critics decry in the adoption by shareholders of dual class stock plans are the result of the SEC's own policies in other areas. Part II maintains that the actual—though unacknowledged—underpinning of Rule 19c-4 is to be found in the Commission's historical insistence upon importing essentially moral-political ideas into corporate economic affairs, an unspoken and unidentified philosophy to be found underneath the formal arguments of other one share, one vote advocates as well. This Comment argues that the moral-political view of the corporation and its shareholders is fundamentally misguided and has obfuscated the legitimate reasons that do exist for government involvement in disparate voting rights transactions. An almost mystical, New England town meeting view of corporate affairs simply has sent the Commission and its supporters down the wrong regulatory path. Part II concludes that the inevitable outcome of such a march of folly is intrusive inalienability regulation containing no conceptual limiting principle and disallowing virtually all dual class recapitalizations, even though there are good theoretical, historical, and empirical reasons to believe that such transactions are frequently legitimate and wealth enhancing.

A more appropriate conceptual device with which to examine dual class recapitalizations is that of the articles of incorporation as a

type of contract that may be modified profitably by the involved parties with respect to voting rights in the corporation. The contractarian view has been prevalent for decades in state decisional and statutory law, at least until Rule 19c-4 effectively nullified such a construction of the corporate charter. Part III develops an alternative regulatory model for dual class transactions based on this contractarian approach. The Calabresi and Melamed concept of liability rule protection is taken from its usual residence in property and tort law and wed to the corporate law concept of dissenter appraisal rights.²⁵ Regulation of dual class transactions based on this more narrowly tailored model likely would result in greater efficiency and philosophical coherence than an inalienability rule approach, and would be less intrusive into the spirit, if not the letter, of state law. Further, the model would alleviate the formal concerns voiced by the SEC and other one share, one vote advocates in justifying regulation such as Rule 19c-4, even assuming such concerns to be valid as stated.

I. THE OVERSTATED FORMAL CASE FOR A ONE SHARE, ONE VOTE RULE

Three basic utilitarian claims constitute the SEC's formal justification for Rule 19c-4 and exemplify those made by other one share, one vote advocates: (1) the presence of coercive collective action and strategic choice problems that prevent true shareholder wishes from being realized in the proxy vote on a recapitalization plan; (2) the belief that dual class capital structures create unacceptably large agency cost problems; and (3) the belief that recapitalizations are not subject to state law fiduciary duty inquiries by the courts. A general ban on dual class recapitalizations has been seen as appropriate under such circumstances, despite the SEC's acknowledgement of the "difficult and complex" issues involved.²⁶

Without a doubt, there is *some* truth in these claims; and depend-

²⁵ Dissenter appraisal rights, despite variations in each state, essentially permit a shareholder to "opt out" of certain fundamental corporate transactions with which he disagrees and withdraw from the corporation. The corporation—that is, the shareholders left over—must then purchase the dissenter's shares at a court determined price reflecting the firm's pre-transaction value. See H. HENN & J. ALEXANDER, *supra* note 11, § 349, at 997-98.

²⁶ See Release, *supra* note 3, at 89,215. The empirical evidence on the wealth effects of recapitalization plans is discussed *infra* notes 199-204 and accompanying text. The SEC did not believe that such evidence was "critical" to the conclusions underlying Rule 19c-4. See Release, *supra* note 3, at 89,217.

ing upon which specific recapitalizations one chooses to focus, more than just some truth. Particularly with reference to the mid-1980s, it is certain that some disparate voting rights plans have been proposed by management with dubious intent, adopted by the corporation in suspect circumstances, and the cause of mischief within that corporation thereafter. In advocating what amounts to a general ban on dual class recapitalizations, though, the SEC and its supporters necessarily set for themselves a very different, albeit unacknowledged, challenge. For a flat ban to be most sensible, these problems must have been pervasive in such transactions, or *systematically* present, over the years. Accumulated knowledge ought to suggest that there is no other possible solution. The historical evidence indicates that this challenge cannot be met satisfactorily. Much of the conventional reasoning backing a one share, one vote rule is inflated relative to the broad scope of Rule 19c-4, and still other components of the conventional argument are based upon problems the SEC itself has helped to create.

A. *Collective Action and Strategic Choice Problems*

1. Collective Action Problems

According to the SEC and other commentators, coercive collective action problems make shareholder defeat of a recapitalization proposal generally unlikely, even though it is the wish of shareholders to do so. One such problem said to plague shareholders is the "freerider" problem, a theory that turns on the absence of a compulsory cost-sharing mechanism among shareholders in a dual class transaction.²⁷

However, freerider problems of the theoretical magnitude supposed by the SEC do not exist in the recapitalization proxy vote; unlike the circumstances usually exemplifying the freerider problem, a basic compulsory cost sharing mechanism *does* exist. Nuisance and pollution cases such as *Boomer v. Atlantic Cement Co.*,²⁸ for example, demonstrate classic freerider economics. There, neighborhood resi-

²⁷ Freerider problems are said to explain why a shareholder who feels that a proposal is not in his best interest will still not organize an opposition. See Release, *supra* note 3, at 89,216 n.73. While the shareholder may gain from opposing the transaction, he will gain even more if other shareholders bear the cost of doing so. Since no compulsory cost-sharing mechanism exists, according to the Commission and its supporters, insufficient incentive exists to organize an opposition, and the individual will simply "freeride" on the efforts of others. See *id.*; Gordon, *supra* note 14, at 44.

²⁸ 26 N.Y.2d 219, 257 N.E.2d 870, 309 N.Y.S.2d 312 (1970).

dents were plagued by dirt, smoke, and vibrations emanating from a nearby cement factory. The severity of the freerider collective action problem was obvious: *somebody* had to go out and sue the firm in order to stop the pollution. Those who did alone bore the full costs of opposition; if the injunction then traditional under New York law in such situations had been granted, public freeriders who did not join as plaintiffs in the suit would still have reaped the benefits of that suit.²⁹

Yet consider the identical situation in the context of a proxy vote on a management proposal that might, say, "pollute" the shareholder "residents" of the corporation. No suit would be needed. Each such "resident" would receive a ballot allowing him to vote on the question of stopping the pollution, or on whether he would accept some specified amount of money in order to allow the pollution. The usual collective action problem would be reduced precisely because a collective action mechanism is built into the proxy voting process itself.³⁰ Nor is this fact particularly surprising. In recognition of the potential effectiveness of the proxy process as a collective action mechanism, one major goal of Congress in the Exchange Act appears clearly to have been maintaining the integrity of and strengthening the proxy process precisely in order to allow dispersed shareholders more effectively to control corporate action.³¹ The result of that voting process can hardly be explained away, as the Commission seems to do, by whispering the phrase "freerider problems" and professing satisfaction that the shareholder recapitalization vote has been discredited on "collective action" grounds.³²

²⁹ See *Boomer*, 26 N.Y.2d at 222-23, 226, 257 N.E.2d at 871-73, 309 N.Y.S.2d at 314-17 (recognizing this in ordering damages for plaintiffs rather than injunctive relief; while the nuisance might have adverse consequences for many parties, only the plaintiffs sought relief, and they would be fully redressed by the damages judgment).

³⁰ Basic corporations texts teach that the proxy voting process serves to check potential freerider problems in collective shareholder action by collectivizing the costs of monitoring management and shifting them to the corporation. See J. CHOPER, J. COFFEE, JR. & C.R. MORRIS, JR., *CASES AND MATERIALS ON CORPORATIONS* 549 (3d ed. 1989) [hereinafter J. CHOPER].

³¹ See S. REP. NO. 792, 73d Cong., 2d Sess. 12 (1934); H.R. REP. NO. 1383, 73d Cong., 2d Sess. 14 (1934); see also S. REP. NO. 1455, 73d Cong., 2d Sess. 74 (1934); Bernstein & Fischer, *The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy*, 7 U. CHI. L. REV. 226, 227-28 (1940).

³² The Commission's discussion in the Release of both freerider and rational apathy, collective action problems constitutes one paragraph and footnote; a remarkably small proportion of the 27 page document, and disappointing given the SEC's heavy reliance on these factors as the basis for its important regulation. See Release, *supra* note 3, at 89,216 & n.73.

Of course, truly organized opposition to a corporate proposal means more than the simple existence of a basic cost sharing mechanism in the proxy vote. Although it says nothing on the subject in the Release, the SEC might also have had in mind other aspects of freerider problems involved in organized opposition to management. As Professor Gordon has written, these problems involve the great expense of communication and coordinated action among dispersed public shareholders.³³ It is difficult, however, to be moved by such a justification for a one share, one vote rule because the SEC is itself an important cause of this problem.

Under the Commission's Rule 14a-2(b)(1), most of the SEC's solicitation of proxy rules would apply to any shareholder wishing to contact more than ten other shareholders concerning the recapitalization proxy vote.³⁴ These proxy rules in turn impose upon the putative insurgent shareholder a maze of regulatory and reporting requirements³⁵ and, inevitably, the significant legal and other professional costs that are by-products of the regulatory state.³⁶ Perhaps the most chilling stricture of all is the SEC's Rule 14a-9, applicable to *any* contact among shareholders with respect to the recapitalization proxy vote, and which would impose liability on an insurgent shareholder for statements later deemed materially false or misleading.³⁷ Worse still, the corporation itself has standing to sue such a shareholder on a claim involving Rule 14a-9 or, indeed, any of the other solicitation of proxy rules.³⁸ Even incorrigible optimists must concede that these regulations would force even a wealthy shareholder to think very hard about making a rebellious sales pitch to fellow shareholders over the recapitalization proposal.

The types of obstacles created for shareholders by Rules 14a-2(b)(1) and 14a-9 also seem a significant cause of the coercive "prisoner's dilemma" type of collective action problem to which the Commission points in prohibiting the exchange offer form of

³³ See Gordon, *supra* note 14, at 46.

³⁴ See 17 C.F.R. § 240.14a-2(b)(1) (1989).

³⁵ See *id.* § 240.14a-3 to -8, -10 to -13.

³⁶ The total cost of a proxy action under these rules runs at least into the tens of thousands of dollars. See Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489, 1500 n.49 (1970).

³⁷ See 17 C.F.R. § 240.14a-9 (1989).

³⁸ See, e.g., *Studebaker Corp. v. Gittlin*, 360 F.2d 692, 695 (2d Cir. 1966) (recognizing a corporation's role in protecting "honest and conscientious" corporate officials from "irresponsible outsiders," and holding that the corporation may seek relief under the solicitation of proxy rules). Note that mere negligence rather than scienter likely suffices to bring liability. See *Aaron v. SEC*, 446 U.S. 680, 695-97 (1980).

recapitalization.³⁹ Although the Release does not explicitly mention the prisoner's dilemma by name, the Commission did explain and implicitly adopt the idea in discussing why the exchange offer form of recapitalization is banned by Rule 19c-4:

The exchange offer is coercive because those shareholders wishing to hold the greater voting stock to defeat the plan would be taking a substantial risk that an insufficient number of outside shareholders will do likewise and majority control will shift to insiders. Accordingly, such shareholders may be "coerced" individually to opt for the lower voting stock with a dividend sweetener to avoid holding ineffective full voting stock, without any dividend benefit.⁴⁰

Even as stated, the prisoner's dilemma strains common sense.⁴¹ Most importantly, though, the theory draws whatever explanatory power it has from the premise that any one shareholder is unable to contact any other. The SEC's solicitation of proxy rules again seem an important reason why shareholders are in effect held incommunicado, because these rules raise the cost of communication from that of a relatively inexpensive mailing to that of a major legal event that might bring significant liability.

Another example of the unjustified alacrity with which the SEC accepted coercion-based rationales in justifying its one share, one vote rule involves institutional shareholders. In supporting its coercion claims, the Commission makes reference in the Release to "testimony from institutional investors describing the pressure placed on managers of corporate pension plans during the shareholder voting

³⁹ See Bermant, *One Share/One Vote, Rule 19c-4: Regulation of Voting Rights*, INSIGHTS, Sept. 1988, at 9 n.15 (noting that the prisoner's dilemma "faced by a shareholder in an exchange offer where collective action is impossible" is "caused principally by the Commission's own Rule 14a-2(b)(1)"). For an explanation of the exchange offer, see *infra* note 150.

⁴⁰ Release, *supra* note 3, at 89,221.

⁴¹ Consider the Commission's precise claim in the quoted paragraph: out of fear that enough other shareholders *might* behave in a manner that assures management of control, a shareholder who fears this outcome will behave in a way that *assures* management of control that much more. Whatever happened to the old-fashioned method of voting against an undesired proposal? The SEC's use of the prisoner's dilemma brain-teaser here to explain shareholder behavior is, with respect, reminiscent of Tweedledee's attempt to guess what was on Alice's mind in the woods: "Contrariwise . . . if it was so, it might be; and if it were so, it would be; but as it isn't, it ain't. That's logic." L. CARROLL, *THROUGH THE LOOKING GLASS AND WHAT ALICE FOUND THERE* 68 (1928). Former SEC Commissioner A.A. Sommer, Jr. has wondered whether there is in fact even "a single shareholder who follows the supposedly universally followed strategy" of the prisoner's dilemma. See Sommer, *One Share/One Vote—The SEC Stumbles*, DIRECTOR'S MONTHLY, Oct. 1988, at 1, 3.

process."⁴² The inference easily drawn by the lay reader is that pension funds and other institutional investors were being muscled into accepting recapitalizations they did not favor. Yet the SEC, and the scholars supporting Rule 19c-4, should have known better than to draw the same general inference. Successful institutional investor activism in opposition to management in the 1980s,⁴³ especially pension fund activism, is by now well documented.⁴⁴ Additionally, although institutional holdings in recapitalizing firms are below the norm, these holdings greatly increased from about 11% before the NYSE moratorium to about 25% after the moratorium.⁴⁵ Unless institutions actively seek to invest their funds in corporations that will abuse them, it is unlikely that the type of coercion to which the SEC refers is a cause for real concern.⁴⁶

These same data also make it difficult to reconcile fully the Commission's freeriding arguments with the fact that freeriding is essentially a phenomenon in which small shareholders exploit large shareholders.⁴⁷ Logically, freeriding must be less of a problem the greater the institutional ownership in the corporation.⁴⁸ The doub-

⁴² See Release, *supra* note 3, at 89,216.

⁴³ See, e.g., *The Battle for Corporate Control*, FORTUNE, May 18, 1987, at 102, 103 (describing many institutional investors as "fed up with executives for mismanaging corporate assets, fending off raiders with greenmail, and, above all, evading market discipline with poison pills, staggered boards, and dual classes of stocks that stack voting power in friendly hands").

⁴⁴ See, e.g., M. LIPTON, J. FOGELSON, A. BROWNSTEIN & C. WASSERMAN, MERGERS AND ACQUISITIONS: DEVELOPMENTS IN TAKEOVER TECHNIQUES AND DEFENSE 103 (1988) (quoting a 1986 study by the Investor Responsibility Research Center that found that the year's proxy season had "witnessed continued growth in the activism of public pension funds on corporate governance questions"). One of the most recent studies concludes that by the end of the 1980s, "a number of major institutions became militant in demanding a heightened recognition of their role in corporate governance," and that institutional investors have frequently been successful at adopting or defeating resolutions over management opposition. See Rosenbaum & Korens, *Institutional Shareholder Activism and Related Proposals for Legislative and Regulatory Changes to Corporate Governance Rules*, in PROXY CONTESTS, INSTITUTIONAL INVESTOR INITIATIVES, MANAGEMENT RESPONSES 623, 629-32 (K. Eppler & T. Gilroy eds. 1990).

⁴⁵ See OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMMISSION, UPDATE—THE EFFECTS OF DUAL-CLASS RECAPITALIZATIONS ON SHAREHOLDER WEALTH: INCLUDING EVIDENCE FROM 1986 AND 1987 at Table 4 (July 16, 1987) [hereinafter OCE UPDATE].

⁴⁶ See also Berman, *supra* note 39, at 9 n.15 (doubting whether such institutional coercion exists). Institutional investor activity, for example, killed a recapitalization plan at Seagram Co. despite the fact that at the time the Bronfman family—which proposed the transaction—controlled 40% of the company's stock. See Hector, *The Flap Over Super-Shares*, FORTUNE, Sept. 16, 1985, at 114, 116.

⁴⁷ See M. OLSON, THE LOGIC OF COLLECTIVE ACTION (1965).

⁴⁸ See J. CHOPER, *supra* note 30, at 549.

ling of institutional outside holdings in recapitalizing firms after the NYSE moratorium gives further reason to believe that freeriding problems are not of the magnitude suggested by the SEC in justifying Rule 19c-4.

The SEC also asserts in the Release the existence of "rational apathy" collective action problems in recapitalization transactions.⁴⁹ This seems another high-sounding theoretical claim of lesser practical validity. In a general sense, any given management proposal that for some reason does deter information gathering by some individual shareholders still would not result in rational apathy with respect to the shareholder group as a whole unless *every* shareholder decides to remain uninformed.⁵⁰ Institutional holdings in recapitalizing firms are high enough to make this scenario very unlikely, and it can be demonstrated mathematically that a typical shareholder's optimal strategy when facing an undesired recapitalization is thus probably not the "pure strategy" of always voting with management suggested by Professor Gordon.⁵¹

The specific content of a recapitalization proposal casts additional aspersions on the potency of the rational apathy theory. The theory, by definition, is powerful only when the object of the proposal is complex or otherwise requires some sort of professional, objective, or market analysis. Only then would the informational costs—the \$X in Professor Gordon's hypothesis—be positive in any meaningful sense. Rational apathy certainly would be expected if the proposal involved the sale of the corporation's sole asset, say, a cyclotron. However, the shareholder vote that is the object of the recapitalization proposal is an inherently personal and subjective item. No general, recognizable "market" for corporate votes exists

⁴⁹ See Release, *supra* note 3, at 89,216 n.73. Professor Gordon, who testified before the Commission, has described the rational apathy theory most succinctly:

[L]et us assume that the shareholder receives a wide variety of management proposals through the proxy machinery, of which only some may reduce shareholder welfare. The shareholder must expend a certain sum, \$X, to hire an expert to analyze the proposal or expend a comparable amount in the foregone opportunity cost of the shareholder's own time. . . . [T]he shareholder will probably conclude that the expected gains are less than \$X. Rational apathy follows, even where the shareholder's vote would determine the matter.

Gordon, *supra* note 14, at 44 n.141. Hence, according to Professor Gordon, rational apathy leads the shareholder always to vote with management. See *id.* at 43-44.

⁵⁰ See Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1610 (1989).

⁵¹ See *id.* at 1607-1610.

in the normal sense of the word.⁵² Only the shareholder himself can determine what value to place upon his voting right as an everyday possession; and the shareholder is in fact asked to do that in a recapitalization proposal.⁵³

The cyclotron, by contrast, is not used by the shareholder himself. Rather, it simply generates cash flows in a recognizable, discrete market, cash flows on which the shareholder has a direct residual claim. This means that the proposed cyclotron sale, unlike the proposed recapitalization, requires an objective or "intrinsic" valuation—a pure mathematical estimation of potential future payoffs that the object of the proposal can be expected to provide without consideration of resale value.⁵⁴ Because the right to vote requires a subjective personal shareholder valuation, the \$X in Professor Gordon's analysis is probably not of the general magnitude he suggests.

2. Strategic Choice Problems

In addition to collective action problems, perceived strategic choice problems⁵⁵ formally underpin Rule 19c-4 and figure prominently in the arguments of other one share, one vote supporters. In one variant of the theorized strategic choice problem, management is said to play "strategic games," inserting into the proxy statement a combination of threats and bluffs.⁵⁶ This particular objection to dual class transactions is a red herring because the Delaware courts have held that such threats will result in the entire transaction being voided or enjoined.⁵⁷ Professor Gordon, for his part, perfunctorily

⁵² The modern general rule is that corporate votes may be alienated temporarily for purposes of specific proxy transactions, subject to judicial scrutiny for intrinsic fairness. See, e.g., *Schreiber v. Carney*, 447 A.2d 17, 24-25 (Del. Ch. 1982). However, stripping the vote from the underlying equity for trading as a generalized market commodity in and of itself is not permitted. See Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 410-11 (1983).

⁵³ See *infra* notes 151-90 and accompanying text.

⁵⁴ See T. COPELAND & J.F. WESTON, *FINANCIAL THEORY AND CORPORATE POLICY* 340 (3d ed. 1988).

⁵⁵ Strategic choice problems generally describe the evils said to arise due to management's control of the structure and timing of the recapitalization proxy proposal. See Release, *supra* note 3, at 89,216; Gordon, *supra* note 14, at 47. The "sweetener" aspect of the strategic choice problem developed by Professor Gordon and referred to by the SEC is discussed *infra* notes 168-90 and accompanying text.

⁵⁶ See Gordon, *supra* note 14, at 50. The language usually suggests that the insider shareholder group values control highly and, if shareholders do not approve the recapitalization, the insider group will not raise other equity capital needed to pursue profitable projects, since this would dilute control. See *id.* at 53.

⁵⁷ See *Lacos Land Co. v. Arden Group, Inc.*, 517 A.2d 271, 278 (Del. Ch. 1986);

recognizes *Lacos Land*, but the case does not seem to faze his analysis. He goes on to construct elegant game theory payoff matrices, modeling expected payoffs and outcomes pursuant to such threats by management, the point of which is to show that such strategic behavior by management stacks the game against shareholders.⁵⁸ That *Lacos Land* seems to demolish the foundation upon which his model is built is something that gets lost in the high powered theorizing. Moreover, Professor Gordon's model of the hypothesized strategic behavior scenario itself seems inappropriate in the specific context of a recapitalization proposal. The model he uses is more appropriate, in game theory lingo, for a "simultaneous move" game; but a recapitalization is instead merely a "sequential" game.⁵⁹

Another aspect of the strategic choice problem that the SEC identifies in the Release arises from management's use of corporate funds to lobby shareholders in favor of the recapitalization proposal.⁶⁰ This argument is another example of how the Commission's own views—in this case, the insistence on seeing the corporation as a miniature democracy⁶¹—tend to hoist the SEC on its own petard. It is well known, for instance, that incumbent members of Congress possess a major advantage in the "frank," the mailing privilege paid for by tax dollars that allows the incumbent to reach his constituents as directly and as frequently as he would like.⁶² The frank is a simple fact of life in a political democracy: an elected representative must be able to communicate regularly with his constituents and cannot be expected to pay the costs of doing so out of his own pocket. Nonetheless, the frank permits the incumbent, in effect, to campaign for the next election. No doubt this is a major factor in the very high re-election rates of congressional incumbents, as the use of corporate funds by corporate incumbents is to their high re-election and proxy success rates.⁶³ The SEC is impotent to change the former situation, but could seek to change the proxy rules "for the protec-

cf. *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1061-62 (Del. Ch. 1987) (enjoining a corporation's self tender for its preferred shares in part due to coercive threats by management to delist those shares unless the preferred shareholders tendered).

⁵⁸ See Gordon, *supra* note 14, at 49-53 & n.166.

⁵⁹ See Romano, *supra* note 50, at 1612 n.44; *infra* note 150 (describing the structure of recapitalizations).

⁶⁰ See Release, *supra* note 3, at 89,216.

⁶¹ See *infra* notes 109-24 and accompanying text.

⁶² See F. LUNTZ, CANDIDATES, CONSULTANTS & CAMPAIGNS 36 (1988).

⁶³ For House members, the average re-election rate from 1974 to 1986 was 93%, reaching a high of 98%. See *id.* at 34 (table of incumbent re-election rates). Similarly, over the 1962 to 1984 period, corporate incumbents won a majority of

tion of investors" in the latter case if it so desired. If it is true that management systematically exploits the proxy process, how about a rule limiting the availability to management of corporate funds for management sponsored proposals, or even a rule forcing management to pay some of the costs? Of course, to conceive of such an idea would be to discard it, since to the Commission the corporation is, after all, a *democracy*. So long as this is the case—so long as the Commission insists on evaluating the corporation against the existing norms of American political democracy—it ought not to grumble about the inevitable results. Labelling them a "problem" justifying SEC action in a *different* area seems a weak analytical methodology that says more about the wisdom of the SEC's own philosophy of corporate democracy than it does about the legitimacy of recapitalization transactions.

B. *Agency Costs*

The SEC adduces various aspects of the classic agency cost problem⁶⁴ in the Release as further support for Rule 19c-4. The Commission's general concern appears to be that, by permanently shifting voting control to insiders, recapitalization transactions lead to "entrenched, inefficient corporate managements acting in their own best interest instead of in the best interest of the company and its shareholders."⁶⁵ The argument certainly *sounds* plausible. The specter of a dictatorship of the mediocre permanently at the helm of the means of production is enough to haunt anyone. This nightmare may be an accurate depiction of *some* recapitalized firms. But is it accurate enough to support a general ban on recapitalizations? The historical evidence, considered together with applicable corporate legal doctrines, suggests not. Indeed, the usual agency costs present in modern public corporations seem conspicuous in their absence with respect to archetypal recapitalizing firms.

Empirical studies demonstrate that, in the average recapitalizing

seats about 75% of the time. See Dodd & Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 J. FIN. ECON. 401, 410 (1983).

⁶⁴ The separation of ownership and control in large public corporations inherently creates a host of potential agency cost problems. Management insiders may divert the firm's cash flow away from shareholders by needlessly spending money on extravagances, perquisites, or plain old managerial inefficiencies. This in turn creates additional costs, also borne by shareholders, to monitor the behavior of management. See Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (Papers & Proceedings 1986) (discussing these conflicting interests between shareholders and management).

⁶⁵ Release, *supra* note 3, at 89,211.

firm, the management insider group's ownership in pure equity terms is very high, on the order of 40% or so.⁶⁶ It is also known that the insider group generally has a very high percentage of its own personal wealth invested in the firm.⁶⁷ The control group therefore is highly vulnerable to the wealth effects of its own decisions; looting or waste of corporate resources is unlikely to occur for the simple reason that management would in large part be stealing only from itself.⁶⁸ Moreover, in the classic recapitalization, the dominant insider group is the family or descendants of the original entrepreneur who started the business.⁶⁹ The shifting of control to such a group is likely to result in low agency cost risk due to the unique social relationships among the group members.⁷⁰ Each member is tied to the firm's fortunes by blood and honor, by personal prestige and family reputation.

These factors differentiate the control group in most recapitalizing firms from any other control group, including management groups taking a public firm private. Whether, say, a DuPont would be able to behave with wanton disregard and profligacy as fellow family members within the company looked on is, intuitively, doubtful.⁷¹ Even on *Dynasty* or *Falcon Crest*, familial duty and loyalty often

⁶⁶ See OCE UPDATE, *supra* note 45, at Table 4; Jarrell & Poulsen, *Dual-Class Recapitalizations as Antitakeover Mechanisms: The Recent Evidence*, 20 J. FIN. ECON. 129, 141 (1988). This stands in marked contrast to the usual situation in large public corporations, where median equity ownership of CEO's, for example, is a paltry .25%. See Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1842 (1989).

⁶⁷ See J. CHOPER, *supra* note 30, at 543. The family-insider group of American Family Corporation, for example, has invested in the company about 75% of each individual's net worth. See AMERICAN FAMILY CORP., ANNUAL REPORT 5 (1987).

⁶⁸ This conclusion is further reinforced by the fact that there is no significant sell-off of the equity interest by the insider group after the recapitalization. See Partch, *supra* note 10, at 332.

⁶⁹ See T. COPELAND & J.F. WESTON, *supra* note 54, at 742 (noting that "significant family involvement found in sample firms"); DeAngelo & DeAngelo, *Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock*, 14 J. FIN. ECON. 33, 34, 63-68 (1985) (noting "substantial" family involvement in recapitalizing firms; ownership data indicates such involvement present in 30 of 45 firms studied); *infra* note 73.

⁷⁰ See T. COPELAND & J.F. WESTON, *supra* note 54, at 742 (noting that the "social sanctions arising out of the significant family involvement found in the sample firms" serve to keep managerial opportunism in check); Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 306 (1983) (stating that family control in an organization provides advantages in disciplining and monitoring other relatives in decisionmaking positions due to the nature of the intrafamily relationship).

⁷¹ Nor is this intuition without some evidence, albeit anecdotal. The family-insider group of the Tasty Baking Company swiftly replaced an out-of-favor relative

serve to restrain otherwise unsavory characters.⁷² Nor are the dominant family groups incompetent as managers; the available evidence indicates quite the contrary.⁷³ Recapitalizing firms on average are characterized by positive *net-of-market* stock returns of 45% in the year preceding the recapitalization.⁷⁴ Such performance is remarkable, and further proof that the agency cost argument does not support a ban on recapitalization transactions. The business and financial press reports a similar general conclusion: "At major companies with two classes of stock, horror stories are rare; champions of uniform voting rights can't cite a single example."⁷⁵

The Commission's contention that recapitalizations defeat shareholder interests in connection with the market for corporate control⁷⁶ also seems the product of unwarranted pessimism. There is little historical reason to believe that many of these firms are hostile takeover targets to begin with. Precisely because of the favorable general performance of the firms and their demonstrated ability to deliver the requisite amount of wealth to the shareholders, the discipline of the market for corporate control is probably as much illusion

with another relative as Chairman of the Board in a proxy fight lasting a single day. See DeAngelo & DeAngelo, *supra* note 69, at 54.

⁷² See *Dynasty* (ABC television broadcast); *Falcon Crest* (CBS television broadcast). But see *Dallas* (CBS television broadcast) (competition between J.R. and Bobby Ewing has, at times, threatened the economic integrity of Ewing Oil).

⁷³ The historical list of firms undergoing recapitalizations reads like a "Who's Who" of dynamic American entrepreneurial families: Dow Jones & Company, Hershey Foods Corporation, Kaufman & Broad, Inc., Ford Motor Company, The New York Times Company, Inc., The Washington Post Company, A.C. Nielsen Company, The J.M. Smucker Company, The Gap, Inc., Wm. Wrigley, Jr. Company, Helene Curtis, Adolph Coors Co., DuPont, and so forth. See generally DeAngelo & DeAngelo, *supra* note 69, at 65-68; Gordon, *supra* note 14, at 80-85 (Appendix); Partch, *supra* note 10, at 334-338. DeAngelo and DeAngelo expressed particular interest that their sample firms "are also notable for their production of familiar and successful products." See DeAngelo & DeAngelo, *supra* note 69, at 34.

⁷⁴ See THE OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMMISSION, THE EFFECTS OF DUAL CLASS RECAPITALIZATIONS ON THE WEALTH OF SHAREHOLDERS 32 (June 1, 1987) [hereinafter JUNE 1987 OCE STUDY]. If the data sample is narrowed to firms recapitalizing after the NYSE moratorium, this figure drops to 26.5%, a smaller but still "strongly positive" measurement of superior performance. See OCE UPDATE, *supra* note 45, at 2.

⁷⁵ Hector, *supra* note 46, at 116.

⁷⁶ The SEC appeared persuaded by the argument that ownership of supervoting shares by corporate insiders could defeat the function of the takeover market as a disciplinary mechanism against bad management. See Release, *supra* note 3, at 89,211. Further, the Commission seemed to accept the assertion that recapitalizations deprive shareholders of the opportunity to share in any control premium in connection with the sale of the company; to the extent that insiders held the voting shares they, and not the public shareholders, would receive the control premium paid therein. See *id.*

as reality for many such firms.⁷⁷ Further, courts have proven themselves perfectly capable of blocking the use of supervoting stock as an unseemly defensive tactic in the face of a hostile takeover.⁷⁸ Dual class recapitalizations attempted at such a time might also trigger the extremely enhanced scrutiny of *Revlon v. MacAndrews & Forbes Holdings*.⁷⁹ After all, courts have found that other types of recapitalizations changing control of the firm in the face of an imminent takeover threat merit examination under the *Revlon* standard;⁸⁰ the type of "irreversible" shift in control represented by a dual class transaction might well merit similar treatment.⁸¹ The *Revlon* principle may also reduce the extent to which even already recapitalized firms are insulated from the market for corporate control by requiring authorized but unissued supervoting stock to be sold to a putative bidder for the company in order to dilute the power of the controlling bloc and permit competitive bidding for the inferior voting shares at a premium.⁸²

In any event, systematically equating dual class common stock with defensive takeover tactics seems a mistake. One indication of this error, among others, is that evidence on the wealth effects of recapitalization proposals does not seem to be consistent with the results of empirical studies on the proposal by management of a structural takeover defense.⁸³ Recognizing that recapitalizing firms

⁷⁷ See, e.g., R. GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 27-42 (Supp. 1989) (surveying the most recent evidence and concluding that "displacement of inefficient management, whether inefficient in comparison to other firms in the industry or inefficient in responding to changes confronting their entire industry, is a quantitatively important motivation for acquisitions").

⁷⁸ See, e.g., *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*, 618 F. Supp. 407 (S.D.N.Y. 1985) (enjoining issuance without stockholder vote of supervoting preferred stock which would have made acquisition of Richardson-Vicks by Unilever impossible without the consent of the Richardson family).

⁷⁹ 506 A.2d 173 (Del. 1986).

⁸⁰ See, e.g., *Black & Decker Corp. v. American Standard*, 682 F. Supp. 772, 780-82 (D. Del. 1988) (defensive recapitalization shifting control to management constituted not merely sale of control, but an actual *Revlon* sale).

⁸¹ See, e.g., *Gelco Corp. v. Conniston Partners*, 652 F. Supp. 829 (D. Minn. 1986), *aff'd in part and vacated in part*, 811 F.2d 414 (8th Cir. 1987) (stating that for a recapitalization to trigger *Revlon*, the shift in control must be irreversible).

⁸² See M. LIPTON, J. FOGELSON, A. BROWNSTEIN & C. WASSERMAN, *supra* note 44, at 113. Such a theory has never been tested in court, but it has influenced actual events. Merv Griffin, for instance, forced Donald Trump to negotiate with him in their fight for Resorts International by suggesting to the Resorts board that it sell Griffin enough unissued supervoting shares to bring Trump—who held all outstanding supervoting shares—below the control level so that Griffin could offer a premium for the inferior voting shares. See *id.*

⁸³ Compare *infra* notes 200-04 and accompanying text (pointing out that at worst,

historically constitute a minuscule fraction of all public firms,⁸⁴ and that a high level of hostile merger and acquisition activity existed for years long before the arrival of Rule 19c-4, reports of the death of the market for corporate control in a world of legal recapitalizations would appear premature. As the Justice Department's Antitrust Division pointed out to the SEC in a December 1986 letter, several firms with dual class capital structures in fact have been acquired.⁸⁵

The ability of shareholders to receive much of a control premium for their shares in the sample recapitalizing firms also remains an open question. The historical probability of an unfriendly, pre-recapitalization takeover bid seems very low.⁸⁶ Additionally, even if such an offer were launched, little room exists for a premium of any appreciable magnitude.⁸⁷ Together, the low probability of a takeover bid and the small magnitude of any rational premium offered therein suggest that any expected premium would likely be minimal, even if a single class of stock were retained. Further, the idea that some expectancy of pecuniary gain is being taken away from shareholders by the recapitalization itself is another concern more appealing in theory than in reality. DeAngelo and DeAngelo specifically studied acquisitions of already recapitalized firms and found that in 20 out of 30 cases both stock classes seemed to receive comparable compensation.⁸⁸

recapitalizations result in average share price decrease of .82% to .93%) with J. COPELAND & J.F. WESTON, *supra* note 54, at 741 (finding average price decreases of 2.33% for firms announcing structural takeover defense plans over the 1968-1983 period (citing L. Dann & H. DeAngelo, *Corporate Financial Policy and Corporate Control: A Study of Defensive Adjustments in Asset and Ownership Structure* (December 1985) (manuscript)); see also Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 149-51 (1987) (disputing that recapitalizations may be equated with defensive tactics against takeover threats in a general sense).

⁸⁴ See *infra* note 146 and accompanying text.

⁸⁵ See Ferrara, Carroll & Dozier, *Tender Offers: Toughing It Out*, in *MERGERS AND ACQUISITIONS IN THE 1980s: ATTACK AND SURVIVAL* 285-86 (R. Ferrara ed. 1987).

⁸⁶ See *supra* notes 76-77 and accompanying text.

⁸⁷ See *supra* note 74 and accompanying text.

⁸⁸ See DeAngelo & DeAngelo, *supra* note 69, at 57.

Of course, the fact that fully voting stock generally trades at some premium relative to inferior voting stock indicates that the insider group possesses some sort of realizable value that outsiders do not. Yet this fact alone says nothing about whether the recapitalization transfers wealth to the control group at the expense of public shareholders. As Professor Gordon recognizes, the differential likely reflects the *pre-existing* control premium of the insider bloc as well as any wealth transfer to that bloc pursuant to the recapitalization. Since the exact value of that premium is not known, one cannot necessarily conclude that the recapitalization transfers wealth to the insiders. See Gordon, *supra* note 14, at 32 n.99.

There is yet another twist of irony in the Commission's approach in this area. Despite the SEC's professed concern with the defensive use of dual class transactions, the Commission nonetheless specifically exempted from the reach of Rule 19c-4 the two most effective antitakeover tactics in existence today—the poison pill⁸⁹ and the corporation's strategic defensive use of control-share acquisition statutes.⁹⁰ These exemptions smack of sunshine patriotism. The SEC's stand against defensive tactics seems to go no farther than its ability to toss around the warm slogan of "one share, one vote," without actually resorting to a principled rejection of defensive tactics. Nor can the Commission justify such unequal treatment on the grounds of federalism, since state law permits poison pills as well as dual class recapitalizations.⁹¹ Something else, beyond principled concern for the vitality of the corporate takeover market, appears to have been at work behind the equal voting rights goals of Rule 19c-4.

C. *Fiduciary Duties*

In a final justification for its one share, one vote rule, the SEC claims in the Release that recapitalization plans are not subject to state law fiduciary duty inquiries.⁹² Contrary to the Commission's suggestion, though, fiduciary standards historically have had a definite role in disparate voting rights transactions. Dual class common stock transactions, including recapitalizations, in fact have been reviewed by courts under state law fiduciary duty requirements.⁹³ Recapitalizations involving supervoting preferred stock have been

⁸⁹ See Release, *supra* note 3, at 89,225-26.

⁹⁰ See 17 C.F.R. 240.19c-4(d)(4) (1989); Release, *supra* note 3, at 89,225.

⁹¹ See *infra* notes 133-37 and accompanying text.

⁹² See Release, *supra* note 3, at 89,216 ("The Commission believes that it is preferable for a company's insiders wishing to gain voting control to do so through a repurchase of shares in which such repurchase is subject to . . . judicial review regarding state corporate fiduciary requirements.").

⁹³ See, e.g., *Barris Indus. v. Bryan*, 686 F. Supp. 125, 133 (E.D. Va. 1988); *Baron v. Strawbridge & Clothier*, 646 F. Supp. 690, 697 (E.D. Pa. 1986); *Kahn v. Schiff*, 105 F. Supp. 973, 976 (S.D. Ohio 1952); *Providence & Worcester Co. v. Baker*, 378 A.2d 121 (Del. 1977); *Williams v. Geier*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,283 (Del. Ch. May 20, 1987); *Lacos Land Co. v. Arden Group, Inc.*, 517 A.2d 271, 278-79 (Del. Ch. 1986); *General Investment Co. v. Bethlehem Steel Corp.*, 87 N.J. Eq. 234, 100 A. 347, 349-51 (N.J. Ch. 1917).

similarly scrutinized,⁹⁴ as have "reverse" recapitalizations in which the firm goes from two classes of common stock to one class.⁹⁵

The standard of review emerging at the time of Rule 19c-4's making certainly was not a toothless one. In *Lacos Land Co. v. Arden Group, Inc.*,⁹⁶ Chancellor Allen strongly indicated that the Delaware courts would begin reviewing recapitalization transactions under the stringent "entire fairness" standard.⁹⁷ Although *Lacos Land* did not reach the "fair price" merits of the dual class transaction at issue there,⁹⁸ the brandishment of *Weinberger* seems a clear signal that judicial reviews of recapitalizations on the merits would have been fertile territory for dissenting shareholder-plaintiffs had not Rule 19c-4 mooted the issue. In fact, at least one court actually seems to have applied a test substantially similar to the *Weinberger* "fair price" standard decades ago.⁹⁹

Other courts have applied deferential standards in the past.¹⁰⁰ However, at least with respect to the types of recapitalizations with which the SEC is most concerned, such deference lacks firm historical roots. In *General Investment Co. v. Bethlehem Steel*,¹⁰¹ one of the early leading cases on dual class stock, the corporation was to sell Class B nonvoting stock to the public at large. The court was not hostile to the offering, finding that it fit squarely within the then-operable New Jersey corporate statute governing common stock vot-

⁹⁴ See, e.g., *City Fed. Sav. & Loan Ass'n v. Mann*, No. 84-4010 (D.N.J. Aug. 2, 1985), *aff'd*, 782 F.2d 1027 (3d Cir. 1986); *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*, 618 F. Supp. 407, 409 (S.D.N.Y. 1985); *Asarco Inc. v. Holmes A Court*, 611 F. Supp. 468, 472 (D.N.J. 1985).

⁹⁵ See, e.g., *Honigman v. Green Giant Co.*, 309 F.2d 667, 671-72 (8th Cir. 1962), *cert. denied*, 372 U.S. 941 (1963); *Manacher v. Reynolds*, 39 Del. Ch. 401, 413-26, 165 A.2d 741, 748-56 (Del. Ch. 1960).

⁹⁶ 517 A.2d 271 (Del. Ch. 1986).

⁹⁷ *Lacos Land* involved an exchange offer recapitalization and held that the principal shareholder and chief executive officer who proposed the plan had "a duty to act with complete loyalty to the interests of the corporation and its shareholders." *Lacos Land*, 517 A.2d at 278 (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983)). The "entire fairness" test of *Weinberger* requires a challenged transaction to meet the requirements of both "fair dealing and fair price." See *infra* note 248.

⁹⁸ The transaction ran afoul of *Weinberger's* "fair dealing" prong due to threats in the recapitalization proxy statement. See *Lacos Land*, 517 A.2d at 278-81.

⁹⁹ See *Kahn v. Schiff*, 105 F. Supp. 973, 976-77 (S.D. Ohio 1952) (enjoining an exchange offer recapitalization; even if procedural fairness had existed, the plan wrongfully would have exchanged superior voting control shares destined for management for existing shares at a ratio, or price, well below their actual value).

¹⁰⁰ See *Baron v. Strawbridge & Clothier*, 646 F. Supp. 690, 692-97 (E.D. Pa. 1986) (appearing to apply mere duty of care review).

¹⁰¹ 87 N.J. Eq. 234, 100 A. 347 (N.J. Ch. 1917)

ing rights.¹⁰² Nonetheless, the court warned that a genuine dual class recapitalization—as opposed to the public offering at issue in the case—would have met with a more demanding judicial reception.¹⁰³ Seventy years later, *Lacos Land* provided a good example of what such a reception would look like.

The SEC's fiduciary duty claim also does not take into account the "sale of control" fiduciary standards likely to be applicable whenever agency costs *are* a credible concern. It has been held in different contexts that recapitalizations shifting control to management constitute a sale of control,¹⁰⁴ and courts regularly disallow sale or transfer of control when the percentage of equity underlying that control becomes sufficiently low.¹⁰⁵ The sensible economic rationale implicit in these decisions is that when equity ownership falls below a certain point, the controlling entity is immune to the wealth effects of its own decisions. There seems no apparent reason why this body of law would not be effective in combatting the Commission's oft-repeated fear of recapitalizations vesting control of the firm in persons with a tiny equity investment.

¹⁰² See *Bethlehem Steel*, 87 N.J. Eq. at 246-50, 100 A. at 348-51. The SEC also exempted both initial and subsequent public offerings of lower voting stock from the effects test of Rule 19c-4. See 17 C.F.R. § 240.19c-4(d)(1)-(2) (1989).

¹⁰³ The exact language employed by the court is of particular interest since it addresses an alteration of the voting rights of *existing* shareholders by those with a small equity interest in the firm—both major concerns of the SEC in the Release:

The question [here] is not, however, whether, after a person has purchased stock in a corporation having a certain amount of stock vested with the right to vote, these fellow stockholders may voluntarily separate the right of property from the right to vote, and thus put the control of the corporation in the hands of those having no pecuniary interest therein and deprive the dissenting stockholder of the advice and action of those whose advice and action he may have fairly be said to have contracted for, but rather whether such stockholder is entitled to require that any new stock issued should be vested with the privilege of voting—a very different proposition.

Bethlehem Steel, 87 N.J. Eq. at 237, 100 A. at 349.

¹⁰⁴ See, e.g., *Black & Decker Corp. v. American Standard*, 682 F. Supp. 772 (D. Del. 1988) (defensive recapitalization plan provided for dividend which only management and the firm's ESOP would receive in stock; shifting of control to management by increasing the equity share of management and the ESOP from 7.4% to 55% found to be a "sale of control").

¹⁰⁵ See, e.g., *Caplan v. Lionel Corp.*, 20 A.D.2d 301, 246 N.Y.S.2d 913 (1964), *aff'd* 14 N.Y.2d 679, 198 N.E.2d 908, 249 N.Y.S.2d 877 (1964) (disallowing transfer of control that came with a mere 3% equity holding originally belonging to Roy Cohn). Conversely, courts allow the consummation of control appurtenant to a bloc of equity when the amount of equity is, coincidentally, in the healthy range typical of recapitalizing firms. See, e.g., *Zetlin v. Hanson Holdings, Inc.*, 48 N.Y.2d 684, 397 N.E.2d 387 (1979) (44.4% equity bloc).

It also bears mention that the aftermath of a recapitalization does not give the management control *bloc carte blanche* to damage the remaining, voteless, shareholders. Controlling management stockholders have a long-recognized general heightened fiduciary duty imposed upon them to behave with the utmost integrity.¹⁰⁶ Such duties undoubtedly are further sharpened where, as seems ordinary in the sample recapitalizing firms, the family-management bloc actively involves itself in the selection of firm directors.¹⁰⁷ Additionally, these general protections are buttressed to some degree by specific legal protections for nonvoting shareholders.¹⁰⁸

II. THE CORPORATION AS CONTRACT, NOT NATION-STATE

What accounts for the SEC's embellishment of both the circumstances in which dual class plans are adopted by shareholders and the consequences of such plans? The most likely answer is that the Commission views the corporate vote as a moral right, a view shared by other one share, one vote advocates. Yet moral-political concerns are inappropriate with respect to the relationship between corporation and shareholders, and the failure of the Commission to notice or accept the distinction has obfuscated the proper role of government in the area of shareholder voting rights and sent the SEC down the wrong regulatory path. Because the corporate vote is conceived of as sacrosanct by the Commission, it is quite naturally—though incorrectly—presupposed that a shareholder would never actually *want* to transfer it. The New England town meeting view of the corporation that forms the real basis for one share, one vote efforts such as Rule 19c-4 contains no conceptual limiting principle and misperceives the deliberate, contractarian nature of many recapitalization transactions. Indeed, historically typical recapitalizations often

¹⁰⁶ See, e.g., *Zahn v. Transamerica Corp.*, 162 F.2d 36, 42 (3d Cir. 1947) (shareholder in control of firm's Class B voting shares, and who dominated the directors, management, and affairs of the firm, held to rigorous fiduciary standard and required to prove the "inherent fairness from the viewpoint of the corporation" of a decision to redeem the limited voting Class A shares); see also Berle, *Non-Voting Stock and "Bankers' Control"*, 39 HARV. L. REV. 673, 677-79, 682-90 (1926) (reviewing the aspects of older case law suggesting that control of a corporation by management shareholders results in "rendering them analogous to trustees, imposing many of the duties which trustees normally have toward their *cestuis que trust*").

¹⁰⁷ See *supra* note 71.

¹⁰⁸ See, e.g., DEL. CODE ANN. tit. 8, § 242(b)(2) (1983) (providing that a class of shareholders may vote as a class on any charter amendment which would alter the rights or powers of such class adversely, whether or not the class is otherwise entitled to vote); N.Y. BUS. CORP. LAW § 804 (McKinney 1986) (same).

seem to represent a rational and legitimate use of the contracting process to amend the firm's articles of incorporation: corporate votes are shifted to their highest use value—the family-insider bloc—and overall utility is maximized as a result.

A. *The Moral-Political Basis of One Share, One Vote*

In the 1920s, Professor Ripley set the mold for the view of dual class common stock as a moral threat to democratic ideals. The problem of shareholder voting rights, Ripley wrote, "is a question of devising something as respects the management of property analogous to the system which the fathers of the American constitution sought to introduce into our scheme of political government."¹⁰⁹ Ripley's plea has been heeded since in powerful quarters. Over the ensuing decades, the SEC has persisted in seeing the public corporation as an entity that derives moral legitimacy from the voting participation of average shareholders,¹¹⁰ in the same way that nations gain such legitimacy from the voting participation of their citizens. Under this banner virtually every conceivable aspect of the proxy voting process has been investigated and regulated by the Commission, either directly or indirectly, all with a view towards creating true shareholder democracy.¹¹¹ So comprehensive has been the effort, so painstaking in its requirements, that as Professor Louis

¹⁰⁹ W. RIPLEY, *supra* note 14, at 130.

¹¹⁰ A mystical, natural-law view of the corporate vote never seems to be far beneath the surface in any SEC discussion of the subject. See, e.g., SECURITIES AND EXCH. COMM'N, STAFF REPORT ON CORPORATE ACCOUNTABILITY FOR THE SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 96TH CONG., 2D SESS. 65-68 (Comm. Print 1980) [hereinafter SEC STAFF REPORT] (after admitting that weight of evidence is to the contrary, insisting nonetheless that participation in corporate electoral processes important to shareholders and should be increased); see also Friedman, *SEC Regulation of Corporate Proxies*, 63 HARV. L. REV. 796, 797 & n.4 (1950) (quoting SEC Annual Report as referring to the shareholder's "right of franchise") (emphasis added).

There has never, in fact, really been a legal "right" to equal per share voting power in the form of a law mandating such a right. Rather, the one share, one vote capital structure must be understood as an investment custom, see *supra* note 4 and accompanying text, the outcome of a consensual bargaining process between investors and those seeking to raise capital. See *infra* notes 146-49 and accompanying text. The Commission for years has confused this private convention for a "right." This is the root of the problem with the SEC's approach.

¹¹¹ See Chayes, *The Modern Corporation and the Rule of Law*, in *THE CORPORATION IN MODERN SOCIETY* 40 (E.S. Mason ed. 1960). A brief look at Rules 14a-1 to -12 and Rule 14b-1 confirms the basic truth of this statement. See 17 C.F.R. § 240.10b-5 (1989); *id.* § 240.14a-1 to -12; *id.* § 240.14b-1.

Loss once remarked, the West might never have been won had these rules then been in effect.¹¹²

Predictably, the re-emergence of dual class stocks in the 1980s has induced *angst* among those dedicated to the notion of the corporation as body politic. Serious observers have likened dual class common stock to "apartheid as a system of corporate governance,"¹¹³ and termed the equal shareholder vote a "basic, immutable right."¹¹⁴ Testimony before the SEC even predicted complete eventual removal from the capital markets of money by investors as a result of disparate voting rights plans.¹¹⁵ The sheer implausibility of such an occurrence is a small but meaningful example of the emotions engendered by the issue.

The SEC itself was propelled by this type of passion, as well as the internal logic of its own institutional history, in making Rule 19c-4. At the initial stage of the debate, for instance, three of the five Commissioners expressed the view that "if shareholders were willing to give up their voting rights, it was their privilege to do just that."¹¹⁶ Yet in an apparent regulatory *volte face*, the SEC in the Release justifies the need for Rule 19c-4 in the moral lexicon of the corporation as polity.¹¹⁷ Moral faith to the point of naked mysticism can be seen in the Commission's brief insistence, without any proof whatsoever, that "[s]hareholders who purchase voting shares in a company do so with the understanding that the shares will be accompanied by the voting rights attendant to the stock at the time of purchase."¹¹⁸

True, the SEC spends the bulk of the Release *formally* justifying Rule 19c-4 on more earthly utilitarian grounds, claiming Rule 19c-4

¹¹² See 1 L. LOSS, *SECURITIES REGULATION* 122 (2d ed. 1961).

¹¹³ See Kirk, *Disparate Voting Requires Study, NASD Decides*, *LEGAL TIMES*, Sept. 23, 1985 (quoting the remarks of one practitioner concerning the dual class recapitalization trend).

¹¹⁴ See Lowenstein, *supra* note 6, at 1006.

¹¹⁵ See Release, *supra* note 3, at 89,211.

¹¹⁶ See Lowenstein, *supra* note 6, at 984 (citation omitted).

¹¹⁷ See Release, *supra* note 3, at 89,215 ("A. Need for Rule 19c-4. . . . The Commission continues to believe that the issue of shareholder voting rights has far-reaching implications, and that a rule ensuring a minimum level of shareholder protection from *disenfranchising* actions is appropriate and consistent with the purposes of the [Securities Exchange] Act [of 1934].") (emphasis added); see also Kerbel, *An Examination of Nonvoting and Limited Voting Shares — Their History, Legality, and Validity*, 15 SEC. REG. L.J. 165, 169 (1987) (acknowledging that proponents of equal shareholder voting rights find something "morally objectionable" about arrangements to the contrary).

¹¹⁸ Release, *supra* note 3, at 89,215. Evidence on shareholder expectations invites the opposite conclusion. See *infra* note 156 and accompanying text.

focuses only “on the *process* by which disparate voting plans are created and their effect on existing shareholders.”¹¹⁹ The problem is that if the first claim is true—that shareholders essentially have some sort of immutable right forever to hold their shares in the identical form originally purchased—the *process* by which that form might later be changed should be irrelevant. And indeed, looking beneath the rhetoric, it is. Observe that the actual thrust of Rule 19c-4 involves effects, not process,¹²⁰ and that with a few narrow exceptions,¹²¹ all processes that create dual class stock are prohibited.

Process is in fact ultimately irrelevant in Rule 19c-4, and would for that matter necessarily be irrelevant in any rule mandating equal shareholder voting rights: even if the particular recapitalization at hand were completely free from procedural (or even substantive) sin, it would still be disallowed. That is simply the nature of a one share, one vote rule. Of course, such an uncompromising approach would be explicable without reference to moral values were dual class transactions *pervasively* problematic. Yet as Part I discusses, this is not the case; and still other facts indicate the moral-political basis of Rule 19c-4. The entire concept of rational apathy seems to have been imported from the field of political science.¹²² Most telling of all, the inalienability protection represented by a one share, one vote rule such as Rule 19c-4 is typically reserved by society for when a moral value is at stake.¹²³ On the whole, then, the Commission’s formal utilitarian rationales seem little more than respectable-sounding expedients cloaking quite a different, moral, concern.¹²⁴

¹¹⁹ Release, *supra* note 3, at 89,218; see also *supra* notes 27-108 and accompanying text (discussing the SEC’s collective action, strategic choice, agency cost, and fiduciary duty justifications for Rule 19c-4).

¹²⁰ See *supra* note 16 and accompanying text.

¹²¹ Rule 19c-4 lists three transactions that, while creating disparate voting common stock, are presumed not to violate the basic effects test: (1) initial public offerings; (2) subsequent public offerings of stock equal to or lower than existing stock with respect to voting rights; and (3) issuances of equal or lower voting stock in order to effect a “bona fide” merger or acquisition. See 17 C.F.R. § 240.19c-4(d) (1989).

¹²² See Romano, *supra* note 50, at 1607.

¹²³ See Calabresi & Melamed, *supra* note 17, at 1123-24.

¹²⁴ And one that might just as easily be turned around and thrown back at the Commission. Former SEC Commissioner A.A. Sommer, Jr. has chided that once we cut through it all, the end result of Rule 19c-4 “smacks of Central American ‘democracy’: if you don’t like the results of the election, stop having elections.” Sommer, *supra* note 41, at 3.

B. *The Moral-Political View Versus the Contractual Nature of the Firm*

1. General Principles

Moral concerns are, of course, relevant when the discussion is one of political rights. The moral-political impetus behind the one share, one vote movement, however, is fundamentally misguided because the corporation is emphatically not a nation-state or body politic in any meaningful sense. Albert Hirschman clarified the distinction between a citizen in a political democracy and a shareholder when he pointed out that a shareholder—at least in a public corporation—possesses both an “exit” and a “voice” option.¹²⁵ That is, a disgruntled shareholder can easily remove himself from the corporate “society” by selling his shares on the open market any time he wishes.¹²⁶ In contrast, a citizen of a body politic must depend on the “voice” option alone since leaving the country and changing citizenship is not a practical alternative.¹²⁷ Put somewhat more fundamentally, the granting of moral content to shareholder democracy is misconceived because shareholders are not “governed” in any purposeful sense of the word by the corporation in which they have invested.¹²⁸ Morals-based regulations directed at corporate governance are, in this sense, an exercise in “make believe” based on false premises.¹²⁹ The same considerations also provide us with a sound reason why for decades the law has permitted corporate voting rights to be altered in a way that political voting rights cannot.

The difference between polity and corporation further reflects itself in the formal instrument through which the individual relates to the larger entity of which he is a part. While political philosophers have used the vague notion of a “social contract” as an analytical construct for centuries, shareholders have always had a very tangible, detailed, and specific contract that governs the affairs of the corporation of which they are a part: the articles of incorporation. State corporate law traditionally has viewed the articles of incorporation in precisely this contractarian fashion.¹³⁰ The Supreme Court as well

¹²⁵ See A. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY* (1970).

¹²⁶ See *id.* at 20-28.

¹²⁷ See *id.* at 32.

¹²⁸ See Chayes, *supra* note 111, at 40.

¹²⁹ See Manning, Book Review, 67 YALE L.J. 1477, 1489 (1958) (reviewing J.A. LIVINGSTON, *THE AMERICAN STOCKHOLDER* (1958)).

¹³⁰ See, e.g., *Bowman v. Armour & Co.*, 17 Ill. 2d 43, 47, 160 N.E.2d 753, 755 (1959) (stating that articles act as contract both between shareholders and corporation, and among shareholders themselves); see also R. STEVENS, *HANDBOOK ON*

historically has taken the view of the articles of incorporation as a contractual arrangement.¹³¹ Ever since Ronald Coase's classic work on the subject, economists too have viewed the firm generally as a nexus of contracts.¹³²

This contractarian view of the corporation has been particularly conspicuous with regard to shareholder voting rights, which state law for decades has held generally to be a matter for the involved parties to arrange themselves.¹³³ A legal rule of one share, one vote was also unknown at common law,¹³⁴ as was generally any rule on voting rights overriding that which the involved parties arranged contractually.¹³⁵ This legacy continues in the corporate codes to the present day, with statutes in the large majority of states permitting voting rights to be restricted or otherwise altered by amendment to the articles of incorporation.¹³⁶ One share, one vote efforts such as

THE LAW OF PRIVATE CORPORATIONS § 82, at 328 (1st ed. 1936) ("Membership in a corporation is essentially the result of contract.").

¹³¹ See, e.g., *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 596 (1921) (holding that corporate articles implied a contract among shareholders); *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 592 (1819) (finding that corporate charter a contract for purposes of the contracts clause of the Constitution).

¹³² See Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937); see also Cheung, *The Contractual Nature of the Firm*, 26 *J.L. & ECON.* 1 (1983).

¹³³ See, e.g., *General Inv. Co. v. Bethlehem Steel Corp.*, 87 N.J. Eq. 234, 241, 100 A. 347, 350 (N.J. Ch. 1917) (noting that "[t]he matter [of shareholder voting rights] is one for the stockholders to determine by their contract"); *People ex rel. Browne v. Koenig*, 133 A.D. 756, 759, 118 N.Y.S. 136, 138 (N.Y. App. Div. 1909) ("[I]t is perfectly lawful for different classes of stockholders to agree amongst themselves, through the certificate of incorporation, that one class shall have no vote . . . and that such an agreement does not contravene public policy . . ."); *Miller v. Ratterman*, 47 Ohio St. 141, 158, 24 N.E. 496, 500 (1890) (noting that an articles provision restricting voting rights is "but an arrangement between two classes of stockholders which did not concern the public"); see also Kerbel, *An Examination of Nonvoting and Limited Voting Common Shares—Their History, Legality, and Validity*, 15 *SEC. REG. L.J.* 37, 51 & n.40 (1987) (noting that traditional state law approach to corporate voting rights has been one of freedom of contract and not a "public policy" of one share, one vote).

¹³⁴ See Ratner, *supra* note 2, at 10 (finding that "there does not seem to have been any" common law rule concerning corporate voting rights, and that if there were such a rule, it probably was one shareholder, one vote).

¹³⁵ See, e.g., Comment, *Delaware Resurrects the Common Law: Affirmation of Contractual Voting Restrictions Within a Class of Stock*, 4 *DEL. J. CORP. L.* 154, 165 (1978) (noting that in the history of the state of Delaware, for example, the "one share, one vote concept . . . was specifically mandatory for only four years, after which the greater flexibility of contractual voting arrangements was permitted").

¹³⁶ See, e.g., *DEL. CODE ANN.* tit. 8, § 151(a) (1983); *N.Y. BUS. CORP. LAW* § 501(a) (McKinney 1986).

Rule 19c-4 directly contravene this traditional approach to corporate voting rights.¹³⁷

2. Implications of the Moral-Political View

The legitimate scope of and basis for government action in the disparate voting rights area has been obfuscated precisely because of the conventional wisdom's failure seriously to consider the contractarian view of the firm, and its importation of a moral-political view. In a general sense, the moral and political view of the shareholder and his vote contains no limiting principle with respect to government regulation of corporate actions. Problems such as collective action and strategic choice are properly understood as "transaction costs" in the methodology of law and economics; that is, factors present in a transaction that prevent the achievement of a wealth maximizing outcome.¹³⁸ Yet never once does the Commission discuss these transaction costs qua transaction costs in the Release. Rather, these factors concern the SEC not with respect to shareholder wealth maximization, but only with respect to the achievement of true shareholder democracy.¹³⁹

Every law and economics analyst knows that high transaction costs such as those the Commission, Professor Gordon, and others believe to exist in recapitalizations dictate the narrow and flexible liability or "damages" rule form of legal protection.¹⁴⁰ Yet because the corporation is viewed in moral terms by one share, one vote

¹³⁷ The types of recapitalizations disallowed by Rule 19c-4, for instance, have been specifically upheld by state law courts. *See, e.g.*, *Providence & Worcester Co. v. Baker*, 378 A.2d 121, 124 (Del. 1977) (upholding capped voting plan); *Williams v. Geier*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,283, at 96,408 (Del. Ch. May 20, 1987) (dismissing challenge to length of time plan). Moreover, the Supreme Court has recently affirmed state authority in this area. *See CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987) ("No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders.") (emphasis added).

¹³⁸ This is the principle implicit in the famous Coase Theorem: "If there are positive transaction costs, the efficient outcome may not occur under every legal rule. In these circumstances, the preferred legal rule is the rule that minimizes the effects of transaction costs." A.M. POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 13 (1983).

¹³⁹ Compare Release, *supra* note 3, at 89,217 ("[T]he Commission does not consider evidence on shareholder wealth effects to be critical to its conclusions.") with *id.* ("[T]he Commission believes that the investor protection and shareholder suffrage policies of the [1934] Act compel action in this area . . .") (emphasis added). Hence, the Commission applied what could be called a "political" Coase Theorem.

¹⁴⁰ *See* R. POSNER, *ECONOMIC ANALYSIS OF LAW* 62 & n.5 (3d ed. 1986); *infra* notes 205-08 and accompanying text.

advocates, these transaction cost factors are used instead to justify a broad and inflexible inalienability form of legal protection, and, as a result, given an ominous dimension they simply should not possess.

The application of a politicized Coase Theorem knows no limits. It is a relatively simple matter to determine when an internal corporate transaction is efficient or inefficient; but there is no telling the point at which it becomes "good" or "bad," just or unjust, by the standards of Western democratic morality.¹⁴¹ The very philosophy and chain of argument that produced Rule 19c-4 could for the most part be applied to disallow virtually any shareholder vote in a large public corporation whenever somebody with power and influence decides that the proposal is "bad" for shareholders; or when the SEC simply decides that such a ban is in the "public interest." This is not hyperbole: clear signs that this internal logic is gaining momentum can be seen in the most recent writings of Rule 19c-4's prominent proponents.¹⁴² Indeed, while transaction cost rationales are without a doubt profitable tools for economic analysis, such concepts can be hazardous even when applied in the proper context. The seductiveness of transaction cost analysis lies in its potential for malleability. Scholars at times fall prey to a regrettable tendency to begin by bandying about a few transaction cost hypotheticals, and then to proceed without more to the claim of having "demonstrated" the proposition they set out to prove. The hazard of course is that what are at bottom normative desires of the decisionmaker or law-giver are given the appearance of being true as between the actual parties to a transaction. To take an example, consider that the exact same freerider and rational apathy rationales used by the SEC to justify Rule 19c-4—a regulation which bans corporate vote transfers—have also been used by another scholar to *justify* a diametrically opposed theory of corporate vote selling.¹⁴³

¹⁴¹ Cf. Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 226 (1962) (protesting that "we have enough problems in the corporate field without importing additional nettles from the democratic political process").

¹⁴² In a recent article, Professor Gordon reiterates the same collective action and strategic choice rationales originally developed in his dual class common stock article and adopted by the SEC as justifications for Rule 19c-4. Yet now the apparent target of inalienability regulation is not some particular shareholder vote but rather shareholder votes in general: the new suggestion is that internal corporate legal rules should be mandatory and unalterable by shareholder majority action. See Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573-85 (1989).

¹⁴³ See Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776, 779-84, 789-90 (1979). Clark considers dual class transactions substantively comparable to

In a more narrow sense, the moral and political view of the shareholder and his vote leads to a misperception of what is really going on in disparate voting rights transactions. The rational apathy theory, for example, was developed by political scientists to explain only why people do not vote in elections, not why they vote in a particular way.¹⁴⁴ Yet this is not the way the theory is used by the SEC and Professor Gordon.¹⁴⁵ Non-contextual misapplications of political theory, of which the rational apathy example is typical, steer one share, one vote supporters away from significant historical factors regarding shareholder voting rights. Chief among these is that equal voting rights have always existed in the vast majority of public corporations, even taking into consideration the recapitalization trends of the 1920s and 1980s, long before Rule 19c-4 ever arrived.¹⁴⁶ Decades of contractual freedom allowed by state law to arrange voting rights in whatever manner the involved parties desired—in addition to the freedom any corporation enjoyed to list itself on the AMEX or OTC markets, which before Rule 19c-4 always permitted deviations from the one share, one vote principle¹⁴⁷—never altered the overall one share, one vote *outcome* of the process. As Easterbrook and Fischel remark, large public corporations continue to conduct votes, often in addition to those required by law.¹⁴⁸ If even half of the formal factors alluded to by the SEC in justifying Rule 19c-4 existed, corporate voting rights would have disappeared quite some time ago. Yet this is not, historically, what has occurred.

Properly understood, corporate voting is but the product of a

his vote selling scheme. See *id.* at 803. Perhaps this explains why transaction costs “have a well deserved bad name as a theoretical device . . . because there is a suspicion that almost anything can be rationalized by invoking suitably specified transaction costs.” Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 233 (1979) (quoting Stanley Fischer).

¹⁴⁴ See Romano, *supra* note 50, at 1607.

¹⁴⁵ See *supra* note 49 and accompanying text.

¹⁴⁶ As of 1985, only 170 of the nearly 5000 companies publicly traded on the American Stock Exchange and over-the-counter (OTC) markets possessed dual class capital structures. See Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 707 (1986). Additionally, from 1962 to 1984, only 44 publicly traded firms on all markets created a second class of limited voting stock. See Partch, *supra* note 10, at 313.

To be sure, there was an observable jump in dual class recapitalizations after the NYSE moratorium: 29 in 1986 and 16 in 1985, compared to 10 in 1984. See Jarrell & Poulsen, *supra* note 66, at 135 (Table 1). Yet the number dropped sharply to 14 in 1987. See *id.* In any event, the addition of these numbers to the total number of firms recapitalized as of 1985 does not change the fact that dual class firms constitute a tiny fraction of all public firms.

¹⁴⁷ See Kerbel, *supra* note 133, at 66.

¹⁴⁸ See Easterbrook & Fischel, *supra* note 52, at 398.

contractual process in which common shareholders generally demand, and receive, the vote as compensation for bearing the residual risk of firm failure.¹⁴⁹ The overwhelming and continued historical existence of equal shareholder voting rights reflects the outcome of just such a contractual process. Similarly, one might expect that the extinguishment of the voting right in those comparatively few corporations in which this has occurred also often reflects the outcome of a contractual process with a rational, underlying purpose.

C. *The Recapitalization as Contractual Arrangement*

1. The Backdrop of the Typical Recapitalization

Although the transaction can take a variety of specific forms,¹⁵⁰ every dual class recapitalization at bottom involves the ultimate transfer by an outside shareholder of his vote to the family-insider bloc, which typically winds up with the superior voting shares. The essential precondition of a legitimate transfer is that it be voluntary and represent rational, economically based wishes. The conventional analysis would claim that general, coercive collective action and strategic choice problems refute the voluntary nature of such transactions. Yet these objections are in the main embellished.¹⁵¹ Indeed, the background circumstances of the typical recapitalization indicate that this precondition is met.

The most important reality to be acknowledged is that in the large majority of circumstances, individual public shareholders simply do not care deeply about their votes. Most such shareholders are in the game primarily for financial gain.¹⁵² For this reason, many

¹⁴⁹ See *id.* at 403.

¹⁵⁰ One method is the "distribution," or "dividend" method, in which existing shareholders receive, pro-rata, shares of new super or limited voting stock they vote to create. Another method is the "voting rights alteration," or "length of time" plan, in which shareholders approve a proposal transforming all shares held for a specified time period by the same individual into supervoting shares. The final basic method is the "exchange offer" recapitalization, which involves shareholder creation of a new class of stock with different voting and dividend rights. Subsequently, each shareholder has the opportunity, in a one time "exchange offer," to exchange existing shares for shares of the new class. The exchange offer can itself be structured in two different ways. In one variant, the new class created is the supervoting class, which carries typically a 10% lower dividend payment than the inferior voting class. In another variant, the new class created is inferior in voting rights but receives the higher dividend payments.

¹⁵¹ See *supra* notes 27-63 and accompanying text.

¹⁵² See A. DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* 611 (3d rev. ed.

have for some time likened the average individual shareholder in a large public corporation to an essentially passive property owner not unlike a bondholder.¹⁵³ In fact, since the first skirmish over recapitalizations in the 1920s, the only people *not* protesting dual class transactions appear to be the average shareholders themselves.¹⁵⁴

With all of the moral indignation over shareholder "disenfranchisement," little attention has been paid to these simple realities. Mysticism, which ought not to have any role in the regulatory process, is at times what the Commission offers in justification of Rule 19c-4. Consider the SEC's bald insistence that shareholders purchase shares with the expectation that the voting right attendant to the stock at the time of purchase will always exist.¹⁵⁵ It seems a mistake to impute this expectation to shareholders, as the available evidence suggests that public shareholders view stock purchases simply as investment rather than ownership decisions.¹⁵⁶ The Commission's claim says more about its *own* normative expectations and desires than it does about those of public shareholders. Probably influenced by the parallel of "one man, one vote," conventional commentators cannot seem even to speak of the fact that many of the shareholders whom they perceive as downtrodden and oppressed may actually *want* to divest themselves of the voting right—provided that the circumstances are appropriate. Precisely because the agency

1934); J. LIVINGSTON, *THE AMERICAN STOCKHOLDER* 38 (1958) ("[S]tockholders, for the most part, are . . . investors, who for the most part, do not wish to be bothered—except by dividends."); Rostow, *To Whom and For What Ends is Corporate Management Responsible?*, in *THE CORPORATION IN MODERN SOCIETY* 53-54 (E. Mason ed. 1960) (pointing out that "[m]ost stockholders . . . are interested in their stock only as investments"); see also *Moneymen May Stop Deep-Sixing Proxies*, *BUS. WK.*, Mar. 20, 1989, at 142 (noting that only about half of shareholders vote in any given proposal). Significantly, at least one study by the SEC's own Division of Corporation Finance invites the same conclusions. See SEC STAFF REPORT, *supra* note 110, at 66 & n.5 ("The majority of commentators expressed the view that shareholders have little interest in participating in corporate governance—they are interested primarily in the economic performance of their corporation.").

¹⁵³ See McDaniel, *Bondholders and Corporate Governance*, 41 *BUS. LAW.* 413, 416-17 (1986); Wood, *The Status of Management Stockholders*, 38 *YALE L.J.* 57, 59 (1928).

¹⁵⁴ See W. RIPLEY, *supra* note 14, at 86-87 (lamenting that "the amazing thing is that this final deathblow to the exercise of voting rights by the general public [i.e., dual class capital structures] has brought no voice of protest"); Wood, *supra* note 153, at 59-60 (suggesting that this "popular indifference" is precisely the result of the fact that the average shareholder only considers himself a passive investor).

¹⁵⁵ See *supra* note 118 and accompanying text.

¹⁵⁶ See Soderquist & Vecchio, *Reconciling Shareholders' Rights and Corporate Responsibility: New Guidelines for Management*, 1978 *DUKE L.J.* 819, 835-37 (study of about 500 dispersed public shareholders revealed that over 90% viewed the decision to purchase stock as an investment decision rather than an ownership decision).

cost risks of the recapitalization are historically of a very low magnitude¹⁵⁷ and the family-insider bloc typically is worthy of control,¹⁵⁸ the general circumstances for a shift in control would seem often to be correct from the point of view of shareholders.

On the demand side of the recapitalization, the critical analytical principle is that the voting right tends to follow those who bear the greatest residual risk of firm failure.¹⁵⁹ The family-insider bloc typical of so many dual class transactions seems clearly to fit the bill. Recall that this group usually possesses a very high percentage of equity in the firm.¹⁶⁰ This alone does not differentiate the insider bloc from any other major shareholder, and would not alone make legitimate a desire for outright voting control of the firm without additional investment of some sort. What *does* legitimize such a desire is the high percentage of personal wealth often invested in the firm by this group,¹⁶¹ and the group's very significant investment in the corporation of firm-specific human capital.¹⁶² No other shareholder or group of shareholders could claim *systematically* such a risk-bearing status. Significantly, the frequent presence of a high firm-specific human capital investment by the family-insider group also means that control of the firm has a private value to this group that it does not have to the public.¹⁶³ Again, the basic elements of a trade would seem frequently to be present.

2. The Recapitalization Itself

The specific features of actual recapitalizations give further indication that such transactions often are borne of legitimate economic motives. Virtually all recapitalizations involve some tangible collat-

¹⁵⁷ See *supra* notes 64-88 and accompanying text.

¹⁵⁸ See *supra* notes 69-75 and accompanying text; *infra* note 162 and accompanying text.

¹⁵⁹ See Easterbrook & Fischel, *supra* note 52, at 404.

¹⁶⁰ See *supra* note 66 and accompanying text.

¹⁶¹ See *supra* note 67 and accompanying text.

¹⁶² Certain people sometimes possess an ability that is difficult to transfer and which makes their involvement in a particular firm that much more valuable. Such persons, therefore, require higher compensation in some form in return for this "firm-specific" investment of human capital. See Fischel, *supra* note 83, at 137-38; Williamson, *supra* note 143, at 244. Examples of such firm-specific human investment include historical knowledge of customer relations and know-how in maneuvering in a firm's culture. See Gordon, *supra* note 14, at 18 n.46. It requires no great leap in faith to believe that firm-specific, human capital items, while ethereal in the most contexts, are present when the firm at issue is a long-time family enterprise; this is especially the case when the family members have invested much in the firm's equity.

¹⁶³ See R. GILSON, *supra* note 77, at 112.

eral transfer of wealth—either 10% or so higher dividend payments or cash payouts—to the lower voting shares.¹⁶⁴ The most obvious interpretation of this transfer is as compensation for the votes being transferred to the superior voting shares. This would establish the nature of the transaction as legitimate and potentially Pareto-optimal.¹⁶⁵ Further, this interpretation is squarely in line with the history of dual class transactions¹⁶⁶ and is most sensible given the general background circumstances of the recapitalization itself.¹⁶⁷ According to the SEC and Professor Gordon, however, these wealth transfers are not a compensatory mechanism but rather “sweeteners” designed to coerce shareholders into giving up their voting shares, another dimension of the asserted strategic choice problem.¹⁶⁸ Rather than cast aspersions on recapitalizations, however, these arguments lend unintentional support to the legitimacy of many such transactions.

Generally, strategic choice manipulation of the proxy proposal in favor of the insider bloc is not possible where shareholder preferences are “single peaked,” that is, where there is a true majority preference.¹⁶⁹ Preferences are indeed often single peaked in public corporations.¹⁷⁰ As if to confirm the point, Professor Gordon’s own raw data shows that in 12 of the 17 firms he sampled, the recapitalization was approved by a majority of *outside* shareholders.¹⁷¹ No cram down phenomenon is apparent from the data.

The most significant problem with the sweetener argument, however, is that its premise is incorrect in a way that highlights

¹⁶⁴ See Gordon, *supra* note 14, at 79-85 (Appendix).

¹⁶⁵ See E. MANSFIELD, *MICROECONOMICS* 440 (4th ed. 1982) (defining Pareto optimality as that which makes someone better off without harming another).

¹⁶⁶ During the recapitalization trend of the 1920s, the *Harvard Business Review* commented that “[a] large group of investors is willing to exchange their voting rights, inherent in all stock, for a steady and fixed rate of dividend and a supposed lessening of the risk as contrasted with that of common stock.” *The Development of Class A and Class B Stocks*, 5 HARV. BUS. REV. 332, 334 (1927).

¹⁶⁷ See *supra* notes 150-63 and accompanying text.

¹⁶⁸ See Release, *supra* note 3, at 89,216; Gordon, *supra* note 14, at 48-49. The basic argument is that, because the insider bloc typically owns a large percentage of shares, the sweetener is essentially a “cram down” vehicle designed to put the insider bloc just over the top in obtaining passage of the recapitalization proposal. See *id.* at 49. The additional claim that the amount of cash transferred in no way corresponds to the actual value of the vote is intended to reinforce the basic argument. See *id.* at 58.

¹⁶⁹ See Romano, *supra* note 50, at 1611.

¹⁷⁰ See *id.* at 1611-12. By insisting that public shareholders generally do not favor recapitalizations, the SEC itself seems tacitly to accept the same proposition.

¹⁷¹ See Gordon, *supra* note 14, at 80-85 (Appendix).

everything that is wrong with the SEC's philosophical approach in Rule 19c-4. The basic one share, one vote argument presumes that, because of the recapitalization's cram down context, shareholders do not value their votes highly.¹⁷² It is, in fact, true that the value of a vote in a typical recapitalizing firm is negligible. Yet the myopic, obsessive tendency to see every corporate event as public shareholder oppression by the inside shareholders—in short, the moral-political view of the corporation—causes the Commission and its supporters incorrectly to presume *why* the vote is of negligible value. In his work on the corporate voting right, Henry Manne pointed out that the value of a vote in any given corporation is also inversely related to the capital gains appreciation of the firm's underlying equity and the efficiency of the firm's management.¹⁷³ Significantly, the classic historical profile of recapitalizing firms includes high capital gains over the period preceding the transaction and highly efficient, entrepreneurial management.¹⁷⁴

It is primarily for these reasons, and not so much because of the cram down potential, that the value of the vote is minimal. The distinction is substantively critical, establishing that the low public value of the votes transferred frequently is quite properly traceable to genuine, underlying economic factors—and not to coercive cram down factors. Nor is such a conclusion surprising, for it comports neatly with the background reality in many recapitalizing firms that the family-insider group values control more highly than does the public.¹⁷⁵ Hence the recapitalization more likely than not should be, in an *ex ante* sense, voluntary and presumably wealth enhancing from the point of view of public shareholders. These underlying structural factors give good reason to believe that the contractarian process of articles amendment frequently is being used rationally to shift voting control of the firm to its highest use value—the family-insider group. It also bears re-emphasis that the common law, a body of law usually associated with a tendency towards efficiency and wealth maximization, contained no contrary mandatory rule of one share, one vote.¹⁷⁶ The fact that a great many recapitalizations of all types

¹⁷² See J. CHOPER, *supra* note 30, at 563; *supra* note 168. As a result, the sweetener is said to lure in just enough shareholders to put management over the top and secure passage of the proposal.

¹⁷³ See Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1430 (1964).

¹⁷⁴ See *supra* notes 73-75 and accompanying text.

¹⁷⁵ See *supra* note 163 and accompanying text.

¹⁷⁶ See *supra* notes 134-35 and accompanying text.

increase shareholder wealth¹⁷⁷ lends empirical credence to such propositions.

Other specific features of dual class recapitalizations help confirm the essentially contractarian nature of many such transactions. Chief among these are the bonding mechanisms¹⁷⁸ typically present in such transactions. In all observed cases, the supervoting shares to be held by management revert to normal voting shares whenever transferred outside the family-insider bloc. Rather than representing yet another evil dimension of such transactions, the transfer restrictions assure that only those who have a great deal of their own money at risk in the firm and who have made the firm-specific, human capital investment have the privilege of control.¹⁷⁹ The agency cost effects of the recapitalization thus are kept to the lowest possible level; the possibility of supervoting control being used to extract control rents from the firm's cash flows rather than to increase the value of the firm is greatly reduced by the transfer restrictions.¹⁸⁰ This interpretation comports with empirical studies indicating that the family-insider group's goal in the recapitalization is increasing the firm's cash flows, not the mere attainment of control for its own sake.¹⁸¹

Additionally, once the recapitalization is taken seriously as a potential contractual arrangement, the 10% dividend differential itself can be seen in part as a bonding mechanism. The goal might very well be to calm agency cost fears about the recapitalization, by

¹⁷⁷ See *infra* notes 199-204 and accompanying text.

¹⁷⁸ Bonding costs or mechanisms are sums spent or things done by an agent—here the management shareholder group—to reassure the principal—here the outside shareholders—that no actions will be taken by the agent contrary to the principal's interests. Hence they allow parties to negotiate at least partially around any potential agency cost problem inherent in the relationship. See Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

¹⁷⁹ Cf. *Zetlin v. Hanson Holdings, Inc.*, 48 N.Y. 2d 684, 685, 397 N.E. 387, 388 (1979) (noting that only "those who invest the capital necessary to acquire a dominant position . . . in the corporation have the right of controlling the corporation"). Significantly, the markets that in the 1920s created disparate voting shares also created a mechanism that performed the identical function. The supervoting shares were often held by the firm's investment bankers, who had a substantial investment in the firm. See Berle, *supra* note 106, at 674 (1926). Moral skeptics such as Professor Ripley tended to view this as some sort of social ill demanding solution rather than the rational mechanism that it appears to have been.

¹⁸⁰ Indeed, in one judicially reviewed recapitalization it appears that the family-insider group openly put transfer restrictions into the plan precisely in an attempt to ingratiate the plan with angered shareholders. See *Kahn v. Schiff*, 105 F. Supp. 973, 975-76 (S.D. Ohio 1952).

¹⁸¹ See DeAngelo & DeAngelo, *supra* note 69, at 54-55.

promising continuing payouts of extra cash over the years and thus systematically reducing the amount of cash that might otherwise find its way into management's hands.¹⁸² This view of the dividend differential as in part a bonding mechanism also provides a possible answer to Professor Gordon's complaint that "[i]t would be an amazing coincidence if a *tenfold* increase in votes could be recompensed by a 10% reduction in dividends."¹⁸³ It would be even *more* amazing if, as he claims,¹⁸⁴ the same 10% dividend differential was precisely what was needed in each and every recapitalization to just put the insider bloc over the top in the proxy vote.

A more plausible interpretation is that the dividend differential is in part a symbolic bonding cost, not necessarily, or fully, a precise mathematical calculation of compensation; the real compensation for the vote is, in addition to the remainder of this differential, the shift in control of the firm to the group historically most able to deliver high share appreciation values.¹⁸⁵ In *Lacos Land*, for example, the inside shareholder who proposed the recapitalization had become CEO of Arden in 1976. The company was at that time "in a desperate condition," and its stock was trading at between \$1 and \$2 per share.¹⁸⁶ By the time the recapitalization was proposed less than ten years later the stock was trading at about \$25 per share,¹⁸⁷ an extraordinary appreciation. Though finding the particular transaction in violation of the *Weinberger* fair dealing requirement due to certain threats in the proxy statement,¹⁸⁸ Chancellor Allen recognized that the subjective motive in proposing the recapitalization itself was probably legitimate and even "benevolent."¹⁸⁹ The positive wealth effects of many recapitalizations suggest that such anecdotes have an empirical basis.¹⁹⁰

¹⁸² Contrary to Professor Gordon's claim, then, the recapitalization does seem to provide a real reason to reconsider the firm's payout policy. See Gordon, *supra* note 14, at 48.

¹⁸³ See *id.* at 58.

¹⁸⁴ See *supra* note 168.

¹⁸⁵ See Manne, *supra* note 173, at 1435 (noting that many shareholders prefer to sell the vote but retain the underlying equity security and thus continue to enjoy capital appreciation); *supra* note 74 and accompanying text (pointing out high pre-transaction share value appreciation in recapitalizing firms).

¹⁸⁶ See *Lacos Land*, 517 A.2d at 274.

¹⁸⁷ See *id.*

¹⁸⁸ See *supra* notes 97-98 and accompanying text.

¹⁸⁹ See *Lacos Land*, 517 A.2d at 278.

¹⁹⁰ See *infra* notes 199-204 and accompanying text.

III. THE LIABILITY RULE MODEL: DISSENTER APPRAISAL RIGHTS

The moral-political basis of a one share, one vote regulation such as Rule 19c-4 ultimately disallows virtually all types of recapitalizations, regardless of merit. A regulatory model based on dissenter appraisal rights, by contrast, proceeds from a proper identification of the problem as one of contract rights and protects legitimate individual investor rights without being unduly burdensome to a majority of shareholders favoring a recapitalization. Strong gains in efficiency as well as doctrinal and philosophical coherence result. This more discrete and narrowly tailored approach is, unlike that of Rule 19c-4, able to differentiate legitimate and illegitimate recapitalizations; the former are permitted to go forward and the latter are strongly curbed. The model also provides an effective remedy to the problems conventionally perceived in recapitalization transactions, even assuming such problems to exist as stated by one share, one vote advocates.

A. *The Model: Theory and Philosophy*

Since the recapitalization is potentially a simple modification of the corporate contract and since no moral value is at stake in such a transaction,¹⁹¹ the lawmaker's objective as a matter of theory ought not be to void or disallow the contract but rather to assure that those who dissented from it are not bound by its terms. Corporate law already has developed an excellent vehicle for accomplishing this goal: the dissenter appraisal remedy.¹⁹²

Indeed, long before the creation by state legislatures of statutory appraisal rights, courts arrived at the same result simply by reasoning from the premise of the articles of incorporation as contract. At common law, a single objecting shareholder could prevent the consummation of a merger, sale of assets, or other fundamental corporate change.¹⁹³ A majoritarian view eventually emerged, but one consequence was that a dissenting shareholder in a fundamental transaction involuntarily became a member of an organically different corporation. Fortunately, state governments did not ban merger transactions on the grounds that the dissenting shareholders would be deprived of an immutable right to the corporate shares in their

¹⁹¹ See *supra* notes 125-90 and accompanying text.

¹⁹² See *supra* note 25.

¹⁹³ See Note, *Valuation of Dissenters' Stock Under Appraisal Statutes*, 79 HARV. L. REV. 1453, 1453 (1966).

original form. Rather, as the Pennsylvania Supreme Court came to see things, a dissenting shareholder had a legitimate contract claim:

He [the shareholder] may object that his co-corporators have no power to make a new contract for him, and thereby constitute him a member of a new and different corporation; for it is of the very nature of a contract relation that it can be instituted only by the real parties to it.¹⁹⁴

In the court's view, the appropriate remedy was the familiar rescissionary damages rule of contract law. The corporation was ordered to buy the dissenter's shares at their "value,"¹⁹⁵ a value presumably to be determined without reference to the unwanted merger.¹⁹⁶

Such an approach to dual class transactions is conceptually appealing. The recapitalization would be permitted to go forward; but a shareholder who does not wish to participate in such a fundamental change to the corporate structure would be monetarily returned to the status quo ante at the expense of those favoring the recapitalization. In the terminology of Calabresi and Melamed, the appraisal scheme amounts to "liability rule" protection for the corporate voting right: the right can be taken away by the majority of shareholders, but only upon payment to the dissenters for their shares of an objectively determined price.¹⁹⁷

Because it approaches disparate voting rights transactions from the proper contractarian premise, the appraisal rights model can be expected to result in strong efficiency gains. The critical point is that a great many recapitalizations that would be disallowed by an ina-

¹⁹⁴ *Lauman v. Lebanon Valley R.R.*, 30 Pa. 42, 46 (1858).

¹⁹⁵ *See Lauman*, 30 Pa. at 49.

¹⁹⁶ This is, in any event, the modern statutory approach to appraisal rights. *See, e.g.*, DEL. CODE ANN. tit. 8, § 262(h) (1983) (providing that a dissenting shareholder to be paid "fair value exclusive of any element of value arising from the accomplishment or expectation of" the transaction itself); *see also* Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purpose*, 1980 AM. B. FOUND. RES. J. 69, 70 (1980) (noting the movement of modern corporate law to the position that the articles of incorporation "contract represents a right to receive damages, in the form of cash appraisal, for its 'breach'").

¹⁹⁷ Calabresi and Melamed more fully describe the liability rule theory in this fashion:

Whenever someone may destroy the initial entitlement if he is willing to pay an objectively determined value for it, an entitlement is protected by a liability rule. . . . [L]iability rules involve an additional stage of state intervention: not only are entitlements protected, but their transfer or destruction is allowed on the basis of a value determined by some organ of the state rather than by the parties themselves.

Calabresi & Melamed, *supra* note 17, at 1092.

lienability approach such as that of Rule 19c-4 likely would be, both in theory and in fact, wealth enhancing. The theory has been addressed.¹⁹⁸ The empirical story is not dissimilar. The data on the wealth effects of recapitalizations *overall*—that is, averaging all transactions in a given sample—is somewhat unclear. A study by Megan Partch concluded that “the evidence suggests that shareholder wealth is not affected by the creation of a class of limited voting stock.”¹⁹⁹ Exchange offer recapitalizations involving dividend preferences were found by Partch to have, on average, positive abnormal wealth effects on the order of 2.76% around the announcement period window.²⁰⁰ Other data paint a more negative overall picture, but about the worst that can be found in any comprehensive study on the subject is a relatively small average drop of .82% to .93% in stock price upon announcement of the recapitalization proposal.²⁰¹

The average-based numbers, though, are of limited usefulness in evaluating any specific regulatory course of action. This is, after all, the moral of the old joke about the statistician who had one leg in boiling water and the other in liquid nitrogen and claimed: “On average, I feel fine.” What is beyond dispute is that a healthy percentage of the *specific* transactions studied are characterized by positive wealth effects. For example, Partch found that 44% of the studied transactions had positive wealth effects around the announcement period window.²⁰² When a dividend preference was involved, 55% of the transactions were positive.²⁰³ Similarly, Professor Gordon’s study reports 58% of all transactions being positive; when broken down according to type, 75% of the exchange offers

¹⁹⁸ See *supra* notes 150-90 and accompanying text.

¹⁹⁹ See Partch, *supra* note 10, at 314.

²⁰⁰ See *id.* at 330. Professor Gordon undertook his own study of 19 NYSE firms recapitalizing after the Exchange’s moratorium. Yet he too found “no shareholder wealth effects statistically different from zero for the sample as a whole.” See Gordon, *supra* note 14, at 28. Further, Gordon like Partch found positive abnormal wealth effects for the exchange offer recapitalization on the order of 3.35% around the announcement period window.

²⁰¹ See OCE UPDATE, *supra* note 45, at 1; see also Jarrell & Poulsen, *supra* note 66, at 149 (finding average negative price effects of .82%). This conclusion is not altered even if the sample is broken down into sub-groups according to the type of recapitalization undertaken. See *id.* at 148 (Table 8, Panel A). Professor Gordon’s study did find much larger, statistically significant negative numbers when the sample was broken down in this fashion; but, as he acknowledges, his sub-sample sizes were extremely small and these calculations therefore suspect. See Gordon, *supra* note 14, at 28 n.75.

²⁰² See Partch, *supra* note 10, at 330.

²⁰³ See *id.*

had positive wealth effects, as did 40% of the length of time or "voting rights alteration" plans.²⁰⁴

A flat one share, one vote *diktat* such as Rule 19c-4 would ban all of these transactions. By contrast, a contractarian, compensation-based model is more narrowly tailored and at least theoretically avoids such overinclusiveness. Indeed, the great value of a liability rule in the Calabresi and Melamed framework is that it is flexible. The lawmaker is able to reach efficient results in a dispute despite the presence of high transaction costs and bargaining barriers, and the liability rule is thus well-suited for precisely such circumstances.²⁰⁵ The appraisal remedy also comports neatly with the Coase Theorem and the conditions required for efficient intervention in private economic affairs.²⁰⁶ In utilitarian terms, the appraisal remedy assures that the criterion of Pareto-efficiency is met: the majority gets what it wants and the minority, because of the compensation scheme, is not made worse off.²⁰⁷ Further, Calabresi and Melamed liability rules are particularly appropriate from the efficiency point of view where damages are easily calculable.²⁰⁸ Such rules therefore make sense in the recapitalization context.²⁰⁹ Whatever the administrative expense of an appraisal remedy might be—and it is not being claimed here that such a remedy would come free of charge²¹⁰—it likely would be more than offset by the efficiency gains of permitting these many wealth enhancing transactions to go forward.

The appraisal rights model also makes possible a more sensible

²⁰⁴ See Gordon, *supra* note 14, at 29 (Table 1, Study B).

²⁰⁵ See Calabresi & Melamed, *supra* note 17, at 1119.

²⁰⁶ See *supra* note 138 and accompanying text.

²⁰⁷ See *supra* note 165 and accompanying text. In fact, although there has been some dispute on the matter, one of the most comprehensive historical studies of appraisal rights statutes concludes that legislatures codified such remedies precisely for the same efficiency reasons that motivated the courts. See Carney, *supra* note 196, at 75 n.19; see also Note, *The Right of Shareholders Dissenting From Corporate Combinations to Demand Cash Payment for their Shares*, 72 HARV. L. REV. 1132, 1143 (1959) (noting that "appraisal statutes were enacted to accommodate the interest of the majority shareholders in freedom to effect corporate combinations to that of the minority shareholders in not being compelled to accept fundamental changes in the nature of their investment").

²⁰⁸ See Calabresi & Melamed, *supra* note 17, at 1120.

²⁰⁹ See *infra* note 260 and accompanying text (discussing recent simplification under Delaware law of the traditional valuation method in appraisal proceedings).

²¹⁰ Recent Delaware case law has, however, rendered the maintenance of an appraisal claim far more economical than it has been in the past. Recent proposals on appraisal rights drafted by the American Law Institute would, if adopted, push this trend even farther. See *infra* notes 243-47 and accompanying text.

doctrinal approach to federal regulation of internal corporate governance matters, an area traditionally the province of state law. The model is significantly less intrusive into the letter and spirit of state law than the approach of Rule 19c-4.²¹¹ Some states already expressly provide appraisal rights for articles amendments that adversely affect the specified rights of shares, including the right to vote.²¹² With respect to those states in which this is not the case, as in Delaware, the dual class recapitalization nonetheless seems the type of "fundamental" change in corporate control or nature for which the appraisal right generally is available.²¹³ Some state courts even have held that although a particular transaction is not mentioned in the appraisal statutes, the appraisal remedy will still apply where the transaction is in substance of the type provided for in the statutes.²¹⁴ The proposed model also makes operable to the greatest extent possible the appraisal laws of the state of incorporation.²¹⁵ Even in the most unsympathetic scenario, then, the appraisal rights scheme in no way wreaks the havoc upon state corporate law inherent in the SEC's conventional approach; an approach that would affirmatively negate the letter and spirit of well-settled statutory and decisional laws in virtually all states.²¹⁶

As a matter of philosophy, the appraisal rights model is more

²¹¹ Although he did not file a dissenting opinion, SEC Commissioner Cox publicly objected to Rule 19c-4 on the grounds that matters of shareholder suffrage should remain within the domain of state law. See Bermant, *supra* note 39, at 9 n.2.

²¹² See, e.g., N.Y. BUS. CORP. LAW § 806(b)(6) (McKinney 1986). This is also the approach of the Revised Model Business Corporations Act. See REV. MODEL BUS. CORP. ACT § 13.02(a)(4) (1984).

²¹³ All fifty states and the District of Columbia provide appraisal rights in case of corporate merger or consolidation. See Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 831-32 & n.11 (1984).

Delaware also permits corporations to provide an appraisal remedy for any desired transaction through the articles amendment process. See DEL. CODE ANN. tit. 8, § 262(c) (1983). Some scholars have argued, moreover, that appraisal rights for fundamental transactions should be viewed as an implied contractual term in the articles of incorporation. See, e.g., Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B. FOUND. RES. J. 875, 878-881 (1983). Hence, requiring corporations to provide an appraisal remedy as part of a dual class transaction would not be odious from a strictly doctrinal point of view, even in Delaware.

²¹⁴ See *Farris v. Glen Alden Corp.*, 393 Pa. 427, 143 A.2d 25, 28-31 (1958) (appraisal statute mentioned only merger or consolidation; even though transaction characterized as sale of assets, court concluded that in substance it was a fundamental corporate change of the type for which appraisal rights should exist). But see *Hariton v. Arco Electronics*, 182 A.2d 22 (Del. Ch. 1962), *aff'd*, 188 A.2d 123 (Del. 1963) (rejecting such an approach).

²¹⁵ See *infra* text accompanying note 220; *infra* notes 226-27 and accompanying text.

²¹⁶ See *supra* notes 133-37 and accompanying text.

sensible than the Rule 19c-4 approach because it confines the purpose and role of government to the actual interests of the particular parties at hand; defined rights, not broad controls, govern events.²¹⁷ The baby is not thrown out with the bath water. The model contains a very definite conceptual limiting principle because it tailors the remedy to the damages actually suffered. Surely it cannot be a proper role of government simply to ban any given type of commercial transaction in which someone *might* be made worse off. If this is to be the philosophical guidepost, then the markets might as well be closed down completely; such would be the logical conclusion of a philosophy that reduces group achievements to the lowest common denominator.²¹⁸

B. *The Model: Practical Format and Application*

This section provides a blueprint of the workings and benefits of the proposed appraisal rights model.²¹⁹ The model would require lawmakers purporting to mandate a general one share, one vote rule along the lines of Rule 19c-4 to exempt from such a mandate

any corporate action, provided that the corporation, in taking such action, makes available to dissenting shareholders an appraisal remedy in accordance with the otherwise applicable appraisal and fiduciary laws of the state of incorporation notwithstanding any such law which presumes to deny an appraisal remedy based upon the listing of such class or classes of common stock on a national securities exchange or market or the holding of the shares of such class or classes of common stock by a defined number of shareholders.²²⁰

²¹⁷ Cf. R. POSNER, *supra* note 140, at 343 ("The choice is rarely between a free market and public regulation. It is between two methods of public control—the common law system of privately enforced rights and the administrative system of direct public control—and should depend upon . . . particular contexts.").

²¹⁸ Cf. Rohrlich, *Corporate Voting: Majority Control*, 7 ST. JOHN'S L. REV. 218, 226 n.46a (1933) ("It may possibly be argued that stockholders, like infants, should be protected against their own acts, but if that is to become the guiding principle in corporation law, in order to render it effective, the state must go very much further than it has.").

²¹⁹ The appraisal rights model is merely sketched with reference to Delaware law. Delaware law is generally considered the least "friendly" to shareholders; whatever efficacy the model possesses likely would not be reduced in other jurisdictions.

²²⁰ Lawmakers might also consider suspending the SEC's Rules 14a-2(b)(1) and 14a-9 for proposed transactions that would, if consummated, violate a basic one share, one vote principle. See *supra* notes 34-41 and accompanying text (discussing the role of Rules 14a-2(b)(1) and 14a-9 in causing problems of collective shareholder action).

1. Basic Architecture of the Model

A corporation's board of directors has available to it a number of state statutory enabling provisions that would allow it lawfully to adopt and honor such a remedy.²²¹ Significantly, once the corporation creates the appraisal remedy in order to qualify for the proposed exception, the remedy's existence cannot be evaded. Shareholders must be informed of the existence of the appraisal right.²²² Further, material information concerning the appraisal right must be disclosed to each shareholder, such as the proper means for perfecting that right.²²³

While the model attempts to the greatest possible extent to absorb individual state corporate laws, state statutes that deny the appraisal remedy in the event that the stock is publicly traded or held by a certain number of persons²²⁴ would be rendered inoperative for purposes of the proposed exception. One objective of the remedy is to provide an ex post compensatory mechanism for a shareholder who dissents from the transaction. If such a shareholder is correct in his belief that the transaction is without merit, then ability to sell on the market often would not be compensatory. Since the stock market frequently can be expected to depress the price of the stock in the event of a meritless transaction, the stock market exceptions to the appraisal remedy would defeat the very purpose of the remedy.²²⁵

The draft language also makes operable for purposes of the proposed exception the "entire fairness" standard of *Weinberger v. UOP, Inc.*²²⁶ and its progeny. *Weinberger* and its progeny govern the rela-

²²¹ For example, the remedy could be characterized as a contract between the corporation and its shareholders severally, conditional upon the shareholder lawfully perfecting the appraisal right. See DEL. CODE ANN. tit. 8, § 122(13) (1983) (providing that every corporation shall have the power to make contracts); *id.* § 141(a) (mandating that business and affairs of corporation to be managed by or under the direction of the board of directors). The actual payout of cash, should things ever come to that, could be characterized as a corporate repurchase of stock. See *id.* § 160(a) (stating that corporation may purchase its own shares); *id.* § 244(a)(2) (providing that board by resolution may reduce corporation's capital by repurchasing shares).

²²² See, e.g., DEL. CODE ANN. tit. 8, § 262(d) (1983).

²²³ See *Enstar Corp. v. Senouf*, 535 A.2d 1351, 1356-57 (Del. 1987). Chief among these means is the need to make a written demand for appraisal before the proxy vote on the recapitalization is taken. See DEL. CODE ANN. tit. 8, § 262(d)(1)-(2) (1983).

²²⁴ See, e.g., DEL. CODE ANN. tit. 8, § 262(b)(1) (1983).

²²⁵ See Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CALIF. L. REV. 1, 84 (1969); Schulman, *Shareholder Rights in Acquisition Transactions: A Dissent*, 13 WAYNE L. REV. 1041, 1066-67 (1972).

²²⁶ 457 A.2d 701 (Del. 1983).

tionship between the appraisal remedy and entire fairness fiduciary claims under Delaware law, and build into the model powerful screening devices. Additionally, the absorption of *Weinberger* harmonizes the model with evolving judicial developments at the state level with respect to recapitalizations before Rule 19c-4 was handed down.²²⁷

2. How the Model Might Actually Work

The model creates three screens against illegitimate recapitalizations and their consequences, operative in three periods: (1) the *ex ante* period before the recapitalization is proposed; (2) the period after a recapitalization proposal up through the vote by shareholders on the proposal; and (3) the *ex post* period after the recapitalization is approved, should such a point be reached.

The model, in effect, would be triggered upon mere consideration by management of a recapitalization proposal that would, but for the model's suggested exception, violate a one share, one vote rule. At this threshold stage, the model goes to work deterring bad proposals in two ways. First, the *Weinberger* component of the model establishes that a majority of *outside* shareholders and *independent* directors would have to approve the proposal or else the transaction eventually could face judicial scrutiny under the entire fairness standard,²²⁸ with the burden of proof on the insider management group.²²⁹ This aspect of the model is critical: any recapitalization proposal ultimately would have to stand or fall solely on its own merits, either with outside shareholders or with the courts. Any cram down weaponry otherwise available to the insider group sooner or

²²⁷ See *supra* notes 96-98 and accompanying text. As Professor Andre has observed:

In retrospect, it seems likely that had the recapitalization trend continued and the process and its effects become better understood, the courts would have moved toward a standard allowing them to examine the merits of recapitalization more closely. For example, the "fair dealing and fair price" formula enunciated in *Weinberger* and its progeny would surely have been elastic enough to permit the courts to separate the good deals from the bad ones.

Andre, *A Preliminary Inquiry into the Utility of Vote Buying in the Market for Corporate Control*, 63 S. CALIF. L. REV. 533, 633 (1990).

²²⁸ See *infra* notes 248-262 and accompanying text (describing scrutiny under *Weinberger* and its progeny).

²²⁹ See *Weinberger*, 457 A.2d at 703. Further, the shareholder vote must be fully informed and completely free from fraud, misrepresentation, and the like; otherwise, even approval by a majority of outside shareholders would not save the transaction from entire fairness scrutiny. See *id.* at 712.

later would be neutralized. Second, the appraisal remedy dimension of the model means that a marginal proposal that barely squeaks by could nonetheless be expected to draw a large number of demands for appraisal. Importantly, this constraint on management opportunism exists whether or not the transaction would be able to pass muster under the entire fairness test. The potential cash outflows of such a consummated recapitalization²³⁰ would be of substantial significance.²³¹

Cognizant of these facts, a rational insider group would think very hard indeed about even proposing a meritless transaction,²³² such as a recapitalization designed to protect a poorly performing firm from the discipline of the market for corporate control. Significantly, this deterrent effect is particularly strong precisely when insider holdings are high enough to force a cram down of such a dubious recapitalization. As major shareholders, members of the insider group effectively would be paying the appraisal claims out of their own pockets; and the sums paid out might be even higher if damages are appropriate under *Weinberger*. These facts place a premium on careful ex ante consideration of the proposal by management, with an eye towards how the transaction might later look to, say, Chancellor Allen.

Should a recapitalization proposal actually be made, the model would continue to work during the period in which the proposal is considered by shareholders. Again, the critical factor is the applicability of the *Weinberger* entire fairness and appraisal regime, which hangs as a brooding omnipresence over the transaction. Consider that the prisoner's dilemma objection to recapitalization proxy votes, even if the basic tenets of the SEC's argument on the point were to be accepted, would appear to be largely neutralized by the model. In the exchange offer hypothetically adduced by the Commission,²³³ for instance, the coercive element would be removed from the first stage by the model's effective requirement that a majority of outside share-

²³⁰ See Partch, *supra* note 10, at 317.

²³¹ Interestingly, under Delaware law, the impairment of capital restrictions upon capital reductions may not apply in the context of appraisal payments. Hence, management could not avoid actually making these payments by arguing that the payments would impair the capital of the corporation, however factually accurate that claim might be.

²³² Cf. Kanda & Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429, 463-469 (1985) (contemplating the theoretical potential of appraisal rights as a general monitoring tool against management which reduces the ex ante costs of the agency relationship).

²³³ See *supra* text accompanying note 40.

holders approve the plan. The appraisal right represents an effective solution to the second stage—the decision to exchange or not after the plan is approved—because the coercive fear of being left with less valuable property is eliminated.²³⁴

The theorized rational apathy problem also would seem to be diminished by the proposed model. Under the *Weinberger* regime, fair price claims can be expected to collapse into appraisal claims for the full value of shares.²³⁵ As such, *Weinberger* portends that in the future actual damages claims will revolve around fair dealing and disclosure issues. Put in more fundamental terms, successful claims for damages under *Weinberger* likely will arise not so much because price is too low, but rather because management does not disclose information that speaks specifically to the fairness of the recapitalization terms.²³⁶ Precisely the information Professor Gordon delights in pointing out—such as the market price differentials between limited voting and fully voting shares²³⁷—would have to be disclosed in order to avoid liability. That which management discloses need not be independently discovered by shareholders or at cost to themselves; and the \$X figure in Gordon's rational apathy model²³⁸ would as a result not be of sufficient magnitude to induce rational apathy among shareholders.

A similar paradigm would apply under the model to the other various strategic choice and game-playing theories adduced by the SEC and Professor Gordon.²³⁹ If a shareholder truly opposes the transaction, he need only demand appraisal, vote against the transaction, and be bought out by the others at full pre-transaction value. If the shareholder is correct that the transaction is a bad corporate decision, and it is nonetheless approved, then he will gain and the others will lose. If he is simply wrong about the wealth effects of the recapitalization, then he lives with the decision. In no event would a shareholder have to base his voting decision on the fear that, ultimately, a vote against the proposal might result in an involuntary transfer of wealth.

If after all of this the recapitalization proposal is approved, there

²³⁴ Cf. Fischel, *supra* note 213, at 879 (arguing that appraisal right alleviates the prisoner's dilemma in the conceptually similar case of a two-tier tender offer).

²³⁵ See Berger & Allingham, *A New Light on Cash-Out Mergers: Weinberger Eclipses Singer*, 39 Bus. L. 1, 10 (1983); *infra* note 251 and accompanying text (noting that fair price and appraisal valuation basically identical under *Weinberger*).

²³⁶ See Berger & Allingham, *supra* note 235, at 21.

²³⁷ See Gordon, *supra* note 14, at 32 n.99.

²³⁸ See *supra* note 49.

²³⁹ See *supra* notes 56-59 and accompanying text.

is a good chance that it is a legitimate, wealth-maximizing transaction. After all, it likely will have been approved by a majority of independent shareholders in circumstances essentially free from coercion and pursuant to full disclosure. Moreover, dissenting shareholders would be compensated by the majority. To object to the consummation of a transaction in such circumstances would be to object to two central premises of American corporation and securities law.²⁴⁰ Such a view seems also to have been shared by the Justice Department's Antitrust Division, which in a December 1986 letter to the SEC stated that the NYSE proposal then outstanding—a proposal that required a recapitalization to be approved by a majority of independent directors and outside shareholders²⁴¹—would adequately protect minority shareholders in recapitalizations.²⁴²

Nonetheless, if the transaction is not approved by a majority of outside shareholders in circumstances free from sin, the model again would provide a rather precise mechanism for setting things right. Recent Delaware case law interpreting the *Weinberger* standard is of particular importance. In *Cede & Co. v. Technicolor*,²⁴³ the Delaware Supreme Court held that a shareholder may simultaneously pursue both appraisal and *Weinberger* entire fairness claims in a single consolidated action.²⁴⁴ The *Technicolor* holding greatly minimizes collective action problems in challenging a recapitalization under the proposed model. The somewhat detailed procedures involved in demanding appraisal, and the fact that less than all shareholders typically

²⁴⁰ See, e.g., R. GILSON, *supra* note 77, at 109-10 (noting that from an efficiency point of view, when some shareholders are interested in a vote's outcome for reasons going beyond the value of their shares, traditional corporate law analysis requires approval by a majority of disinterested shareholders in order to legitimize the transaction); T. HAZEN, *THE LAW OF SECURITIES REGULATION* § 1.2, at 7 (1985) (noting that federal securities law traditionally has rejected regulation of the underlying merits of a transaction, presuming instead that investors are adequately protected if all aspects of the transaction are fully disclosed).

Depending upon how the remedy is drafted by the board, the model might provide a vehicle for aborting a recapitalization even at this stage without a single court paper being filed. Should the number of appraisal claims be high, the board might consider calling off an approved recapitalization altogether. Cf. DEL. CODE ANN. tit. 8, § 251(d) (1983) (providing that any merger agreement may contain a provision entitling board to terminate a merger agreement even after shareholder approval). In this sense the model might act as a de facto supermajority provision applicable to recapitalizations, defeating any transaction even arguably without merit.

²⁴¹ See *supra* note 11 and accompanying text.

²⁴² See Ferrara, Carroll & Dozier, *supra* note 85, at 285-86.

²⁴³ 542 A.2d 1182 (Del. 1988).

²⁴⁴ See *Technicolor*, 542 A.2d at 1190-91. No "election" between the remedies is required, although they must be pled in the alternative. See *id.* at 1191.

demand appraisal when it is available, traditionally have rendered class action devices problematic in such a context. Yet entire fairness claims affect all shareholders in the same fashion, and by definition are easy to certify as class action proceedings. Because *Technicolor* allows both types of claims to be coupled in a single proceeding, appraisal claims in essence will be able to "piggyback" on entire fairness claims. As a result, the model in effect makes available the tremendous cost and efficiency benefits of class action proceedings even to appraisal claims.²⁴⁵ Other aspects of the model blend smoothly with the access given by *Technicolor* to such quasi-class action appraisal proceedings,²⁴⁶ and recent proposals on appraisal rights drafted by the American Law Institute—proposals clearly reflecting and amplifying a trend at the state level to make appraisal proceedings a realistic shareholder remedy—would if adopted in the future even further reduce shareholder collective action problems.²⁴⁷

What might a recapitalization challenge based upon the proposed model look like? A dubious recapitalization secured by an insider-group cram down would produce a strong entire fairness claim.²⁴⁸ The fair dealing prong, as formulated by the *Weinberger* court, would seem an effective weapon against precisely the type of potential management chicanery that gives rise to coercive prisoner

²⁴⁵ Cf. J. FRIEDENTHAL, M. KANE & A. MILLER, CIVIL PROCEDURE § 16.1, at 722-23 (1985) (describing the very purpose of class actions as the facilitation of bringing a large number of small claims that, individually, would be difficult to maintain given the relative costs involved).

²⁴⁶ Under the model, a shareholder would possess the right to acquire from the corporation the number of shares for which an appraisal demand was made and the right of access to shareholder lists. See DEL. CODE ANN. tit. 8, § 262(e) (1983); *id.* § 220(b). The planning involved in bringing a class action suit would be greatly facilitated by these rights.

²⁴⁷ Most notable among these proposals is a requirement that shareholders be paid the fair value of their shares within 30 days of perfecting their appraisal rights. The penalty to the corporation for not making such a quick payout is bearing the cost of the entire subsequent judicial appraisal proceeding. See AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 7.22(d) (Tent. Draft Apr. 16, 1990).

²⁴⁸ As the Delaware Supreme Court explained the "fair dealing" and "fair price" components of the entire fairness standard:

The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed [transaction], including all relevant factors All aspects of the issue must be examined as a whole since the question is one of entire fairness.

Weinberger, 457 A.2d at 711.

dilemma, rational apathy, and strategic choice problems. Such problems are, after all, largely coterminous with those circumstances that the fair dealing test and the ultimate availability of an appraisal remedy are effective in combatting.²⁴⁹

Other conventional objections to recapitalizations, such as Professor Gordon's objection to the price aspect of such transactions,²⁵⁰ seem squarely answered by the fair price and appraisal aspects of the model. Under the *Weinberger* regime, fair price and valuation for appraisal purposes are to be determined by "any techniques or methods which are generally considered acceptable in the financial community."²⁵¹ The language seems clearly to carve out a prominent place in the analysis for modern discounted cash flow techniques, and indeed the one reported post-*Weinberger* valuation case portends the primacy of such techniques in valuing shares.²⁵² The market value of the shares on the day before the transaction proposal is announced, a value previously of importance under Delaware law,²⁵³ seems no longer relevant. Hence, one of Professor Gordon's important strategic choice criticisms and objections to appraisal remedies—that management might time a transaction so as to coincide with deliberately released good news about the firm and the inevitable rise in share price caused by such news²⁵⁴—seems rendered superfluous by the model. Even if the market price of the stock were considered relevant for valuation purposes, Professor Gordon's concern is unwarranted because subsequent Delaware case law interpreting *Weinberger* establishes that purposeful management manipulation of a transaction's timing is actionable under the entire fairness standard.²⁵⁵

²⁴⁹ See *supra* notes 233-40 and accompanying text.

²⁵⁰ See *supra* notes 168 & 183 and accompanying text.

²⁵¹ *Weinberger*, 457 A.2d at 713. Interpreting § 262(h) of the Delaware Code, the court added further that appraisal value must be based upon "all relevant factors." Only the speculative elements of value that may arise from the "accomplishment or expectation" of the transaction are excluded. "Clearly, there is a legislative intent to fully compensate shareholders for whatever their loss may be." *Id.* at 713-14.

²⁵² See *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1144-46 (Del. 1989) (Delaware Supreme Court affirming Vice-Chancellor's valuation, based upon expert's discounted cash flow analysis).

²⁵³ See *Levin v. Midland-Ross Corp.*, 41 Del. Ch. 276, 281-82, 194 A.2d 50, 53-54 (1963).

²⁵⁴ See Gordon, *supra* note 14, at 32; Gordon, *supra* note 142, at 1587.

²⁵⁵ See *Rabkin v. Phillip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1105-07 (Del. 1985). Such a holding might also provide a legal basis to future courts for adopting Professor Romano's suggestion that the existence of managerially controllable confounding events create a presumption of negative wealth effects, which

Other aspects of the model present an effective solution to the remaining standard objections to recapitalizations. Recall the SEC's concern that such transactions deprive public shareholders of an opportunity to share in a control premium for the firm.²⁵⁶ While this is an inflated claim with respect to the full history of dual class transactions,²⁵⁷ there can be little doubt that at least some firms recapitalizing in the period immediately preceding Rule 19c-4 did so for defensive reasons borne of dubious intent. In the event that such a transaction were approved despite the operability of the proposed model, the insider group still would not be able to appropriate any control premium under the model. Post-*Weinberger* case law expressly prohibits consideration of any minority-share discount in the valuation of shares and, by implication, forces a sharing of any control premium with dissenting shareholders.²⁵⁸

Professor Gordon recently has objected that appraisal remedies based upon "intrinsic" value could be overcompensatory and deter too many value-creating transactions by encouraging an inefficiently large number of appraisal claims.²⁵⁹ This too is an objection obviated by the proposed model. One of the important holdings of *Weinberger* is the elimination of the old, cumbersome Delaware "block" method of valuation²⁶⁰ that attempted to derive intrinsic value as defined by Gordon. In the post-*Weinberger* world, the objective of Delaware appraisal proceedings is to give the shareholder the substantial equivalent in value to what he had before the transaction.²⁶¹

management would have to rebut. See Romano, *supra* note 50, at 1614. The fact that this sort of management underhandedness implicates, at the least, *Weinberger* fair-dealing values would also support such a legal theory.

²⁵⁶ See *supra* note 76.

²⁵⁷ See *supra* notes 86-88 and accompanying text.

²⁵⁸ See *Cavalier Oil v. Harnett*, 564 A.2d 1137, 1144-45 (Del. 1989). In the court's view:

The application of a discount to a minority shareholder is contrary to the requirement that the company be viewed as a "going concern." . . . [T]o fail to accord to a minority shareholder the full proportionate value of his shares imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder, a clearly undesirable result.

Id. at 1145. *Cavalier Oil* appears to adopt the now infamous rule on the sharing of control premiums enunciated in *Perlman v. Feldmann*, 219 F.2d 173, 178 (2d Cir. 1955).

²⁵⁹ See Gordon, *supra* note 142, at 1587-88. By "intrinsic" value Gordon means value based not upon market price or cash flow analysis, but rather upon net asset value, liquidation value, and other underlying factors. See *id.* at 1587 n.118.

²⁶⁰ See *Weinberger*, 457 A.2d at 712-13.

²⁶¹ See *Rosenblatt v. Getty Oil*, 493 A.2d 929, 940 (Del. 1985).

In the terminology of contract law, this amounts to rescissionary, or restitution, damages. Damages calculated in this fashion are precisely the correct prescription from an efficiency perspective if opportunistic behavior is the concern,²⁶² as it is in Gordon's critique of recapitalization and other management proposed transactions. Further, even if appraisal remedies screen out some legitimate transactions, they are certainly preferable to a general ban that prohibits *all* such transactions.

CONCLUSION

In the 1930s, Berle and Means confidently declared in *The Modern Corporation and Private Property* that shareholder powerlessness was the inevitable, necessary result of the separation of ownership and control. The entire hullabaloo over shareholder democracy and disenfranchisement, they implied, really was irrelevant: the only fundamental course of action would be social control of large public corporations. Berle and Means have remained for five decades an intellectual force to be reckoned with in no small part because they bore the courage of their convictions. Many have disagreed with them, but few question the power and consistency of their arguments.

What of today's SEC? Easterbrook and Fischel offer an unflattering comparison: "Berle and Means thought they had diagnosed a *fatal* disease. They had no interest in the palliatives of the sort the SEC has since adopted; they would have called them costly but pointless."²⁶³ The comparison is particularly apt with respect to the one share, one vote issue. It is interesting to list briefly the thematic contradictions and confusion present in the position of the Commission and other one share, one vote advocates; and to reflect on the pointlessness of a flat one share, one vote rule even as measured by the standards of these very advocates. The SEC and its supporters proclaim that corporate democracy is of paramount importance; yet the formal justifications offered for a one share, one vote regulation turn on coercive factors claimed to be present in any shareholder vote that would, if in fact present, serve only to show that corporate democracy can never really exist. The SEC and its supporters proclaim the powerlessness and impotence of the individual shareholder and his vote as another reason for prohibiting disparate voting rights

²⁶² See R. POSNER, *supra* note 140, at 105-06.

²⁶³ Easterbrook & Fischel, *supra* note 52, at 397.

transactions; yet they ask in the same breath that we accept preservation of this allegedly useless vote as a vital policy goal.

It has been said that the best method of confronting a false theory is to take it literally, and this admonition is particularly relevant in the case of Rule 19c-4. If the formal theories behind such a one share, one vote rule are true—if it is true that collective action, strategic choice, and similar problems discredit the validity of shareholder majority votes—then there is little point to having a rule protecting shareholder voting rights to begin with. As if playing out a role in some bad television sitcom, the SEC is like a doctor who, claiming to have diagnosed a deadly ailment, tells the patient that a nice bowl of chicken soup and a good night's sleep should clear up the problem. At least Berle and Means had the fortitude to tell the patient that the situation was hopeless and that funeral arrangements would be in order.

Happily, though, both Berle and Means and the SEC misdiagnose the corporate patient. There is no fatal disease. Voting in large corporations has been the overwhelming custom in the United States and still continues to be. This Comment has endeavored to show that, in those comparatively few corporations in which the voting right has been extinguished, this outcome often can be explained in terms of a rational contractarian process leading to wealth enhancing transactions. Fixation upon an inappropriate moral-political view of the corporation has blinded the SEC and its supporters to such facts and steered the regulatory process in the wrong direction. Not the slightest curiosity has been expressed that, historically, only a small number of firms — most with strikingly similar characteristics militating strongly against the potential dangers of inferior voting common stock — in fact undergo recapitalizations. Nor has it been recognized that, as with other problems for which the national regulatory impulse has been irresistible, a system of private rights perfectly capable of dealing with the remaining dangers was evolving at the state level from traditional common law doctrines. The unfortunate result of such thinking has been—and could easily be again—a rule that bans virtually all recapitalizations regardless of the legitimacy of many, perhaps most, such transactions.

Professor Gordon voices his concern that “[e]ven if ‘shareholder democracy’ is more illusory than real,” we must assure that “high corporate office is earned and retained on the sufferance of marketplace scrutiny.”²⁶⁴ A legal regime based upon the contractarian

²⁶⁴ Gordon, *supra* note 14, at 78.

remedy of appraisal rights, that works with the marketplace rather than struggling upstream against it, renders Gordon's concern itself more illusory than real.