EQUITY AND DEBT DECOUPLING AND EMPTY VOTING II: IMPORTANCE AND EXTENSIONS†

HENRY T. C. HU†† & BERNARD BLACK†††

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†† Allan Shivers Chair in the Law of Banking and Finance, University of Texas Law School.

††† Hayden W. Head Regents Chair for Faculty Excellence, University of Texas Law School, and Professor of Finance, University of Texas, McCombs School of Business.

We extend our prior work on how both supply (including the emergence of OTC equity derivatives and growth in share lending) and demand (including the growth of hedge funds) factors now facilitate the large-scale, low-cost decoupling of shareholder voting rights from shareholder economic interests. Both inside and outside shareholders, as well as corporations themselves, can engage in what we termed “empty voting”—voting while holding greater voting power than economic ownership. Shareholders can also have “hidden (morphable) ownership”—economic ownership, ostensibly without voting rights, which remains undisclosed under current disclosure rules, but can quickly morph to include voting ownership as well. These forms of decoupling pose important risks to the one-share-one-vote paradigm that underlies conventional models of corporate governance and shareholder voting.

We extend our prior work in five primary ways. First, we treat decoupling of voting rights from economic ownership of shares (empty voting and hidden ownership) as special instances of a more general pattern—investors, and corporations themselves, can unbundle the package of rights and obligations which have traditionally been associated with equity (“equity decoupling”) as well as debt (“debt decoupling”). Second, we provide evidence that equity decoupling is an important worldwide phenomenon, which adds urgency to the need for disclosure and perhaps other reforms. Third, we go beyond decoupling by shareholders, examine decoupling strategies that corporations can use to fend off changes in control, and expand our integrated equity ownership disclosure proposal to address corporate decoupling. Fourth, we propose responses to empty voting which go beyond disclosure, including constrained corporate power to limit the voting rights of empty voters, condensing the period from record date to shareholder meeting date, and encouraging institutional investors to recall and vote lent shares. Fifth, we sketch several extensions of our decoupling framework to (a) the full range of shareholder rights and obligations, (b) debt decoupling, and (c) the possible revival of the “street sweep” takeover strategy.

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INTRODUCTION

Ownership of shares customarily conveys economic, voting, and other rights and disclosure and other obligations. Longstanding legal and economic theories of the public corporation assume that the elements of this package of rights and obligations cannot readily be decoupled—and in particular that voting rights cannot be decoupled from an economic interest in the corporation. The “one-share-one-vote” pattern, with voting rights held in proportion to economic interest, is a familiar instance of this assumption.

This foundational assumption can no longer be relied on. In prior work, we explored the implications of decoupling of voting rights from economic ownership and the resulting gaps in disclosure rules (collectively, Decoupling I).1 We explored why decoupling of vot-

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ing rights from economic interest is increasingly a matter of choice. The emergence of equity swaps and other over-the-counter (OTC) equity derivatives, the growth of lightly regulated hedge funds, related growth in the share lending market, and other factors now permit decoupling of voting rights from economic interest to occur quickly, at low cost, on a large scale, and often hidden from view. Investors can have greater voting than economic ownership, a pattern we termed "empty voting." Conversely, investors can have greater economic than voting ownership, which under current rules often allows them to avoid public disclosure of their ownership. Often, this hidden economic ownership can be quickly transformed to include voting ownership as well, a combination we termed "hidden (morphable) ownership." We referred to empty voting and hidden (morphable) ownership together as the "new vote buying." We set out the functional elements of these two forms of decoupling, provided a taxonomy of decoupling strategies, described the legal and regulatory environment, proposed enhanced shareholder disclosure of both economic and voting ownership, and sketched possible additional responses to empty voting.

In this Article, we reexamine and extend our prior work in light of new developments, which show the real-world significance of these decoupling strategies, illustrate uses beyond those we had anticipated, and confirm the urgency of a disclosure-based response. We also propose additional regulatory responses to empty voting.

This Article is organized as follows. Part I offers an overview of decoupling strategies and uses. We embed empty voting and hidden (morphable) ownership in a new general framework, in which the separation of economic and voting rights is one instance of the broader ability of investors to unbundle much of the package of rights and obligations customarily associated with share ownership. In our prior work, we focused on decoupling by shareholders. Here, we also add decoupling by corporations to an overall family of "equity decoupling" strategies. The firm cannot vote its own shares. But the firm's managers can often use decoupling strategies to arrange for friendly shareholders to hold votes but limited or no economic rights, where the shareholders are expected to support management, and have incentives to do so, or at least no incentives to

[hereinafter Hu & Black, Decoupling I (Finance Version)], near-final version available at http://ssrn.com/abstract=874098 (version directed at finance academics, with expanded theoretical discussion). Below, we refer where appropriate to the first article and, in some cases, the third, but assume general familiarity with this prior work.
vote against management. In one recent takeover battle, for example, a Hungarian firm repurchased 40% of its own shares and lent the shares to friendly banks (thus transferring voting rights but not economic risk). One might call the strategy "soft parking" of shares (we define this term more carefully below). OTC equity derivatives offer other options for the firm to place votes but little or no economic risk with friendly third parties. Employee stock ownership plans (ESOPs) and restricted stock plans place votes, with only limited economic ownership, in friendly hands. And acquirers can be empty voters of target shares, or vice versa. We also develop the uses of decoupling to avoid a number of regulatory requirements, not just ownership disclosure.

A recurring response to Decoupling I from U.S. readers was, "This is interesting, but is it important?" Part II provides fresh evidence. We can now say unequivocally that equity decoupling is an important worldwide phenomenon. Some recent examples have been dramatic, including stealth takeover attempts relying on hidden (morphable) ownership strategies. The managers and shareholders of major firms have woken up one morning to learn that their company suddenly has a new 30% or 40% shareholder.

In Switzerland, decoupling has been the stuff of front page headlines, involving the acquisition of controlling stakes in several leading Swiss firms, the resignation of the CEO of a major Swiss bank for facilitating this hidden ownership, and rapid government responses. Nothing in current U.S. rules prevents similar stealth bids here. Poison pills may do so, but their existence in perhaps half of our major public firms will not help the other half, nor justify regulatory complacency.

More broadly, our list of decoupling examples worldwide (see Part II and Table 1, infra) has grown—from 21 in 2006 to over 80 today, in over 20 countries. Some of the new examples are disquieting. Moreover, our prior examples primarily involved hedge funds and other outside shareholders. A number of the new examples involve corporate decoupling. These examples confirm the importance of insider and corporate decoupling.

In Part III, we refine our earlier integrated ownership disclosure reform proposal to respond to the newly emerging forms of decoupling, especially corporate decoupling, and to expand disclosure of share lending. We also argue that the emergence of sneak takeover attacks in Europe, which could be replicated here, makes disclosure reform urgent. At present, the Securities and Exchange Commission
DECOUPLING II

(SEC) is known to be considering disclosure reforms, but no public proposal has been made. We also review evidence from the U.K., which in 2005 revised its rules for disclosure during takeover bids, and has recently proposed additional disclosure more broadly. The U.K. experience suggests that decoupling around takeover bids is reasonably common, that a disclosure-based response can provide valuable information on its extent, and that disclosure is not very burdensome to filers. Even hedge funds may be coming to believe that derivatives-based ownership should be disclosed. In October 2007, a group of 14 of London's biggest hedge funds called for European regulators to require this disclosure.\(^2\)

Part IV discusses responses that go beyond disclosure, which we believe should be implemented in the near- to medium-term. In our prior work, we sketched possible approaches but believed it was premature to propose specific measures. We now propose that corporate law should allow firms to adopt charter amendments to limit empty voting, subject to an array of limits designed to ensure that these amendments produce better voting, rather than voting tilted toward insiders. We present a specific example of a charter amendment, under which large shareholders could attest to non-empty voter status. We also recommend revising current record date practices to better connect votes to economic ownership, make empty voting more difficult, and address "overvoting" (a practice that, despite its name, often results in valid votes not being counted). And we propose measures to encourage institutional investors to vote shares for which they have economic ownership.

Part V briefly outlines three extensions of our analytical framework. First, we extend the concept of decoupling to the full range of rights and obligations customarily associated with share ownership—call this "equity decoupling." The relevant rights include not only voting rights, but also rights relating to appraisal, directors' fiduciary duties, bringing lawsuits, shareholder proposals, and inspection of corporate records. The relevant obligations include not only disclosure but also, depending on each state's or country's laws, antitakeover laws, mandatory bid requirements, antitrust approval, holding company or investment company status, and short-swing profit recapture. Second, equity decoupling has a close companion in debt markets—call this "debt decoupling." Creditors can use credit derivatives and other means to decouple exposure to default risk from control and

\(^2\) See infra Part III.B.
other rights under loan agreements and bankruptcy law. Corporations may thus have "empty creditors" as well as empty voters, "hidden debt ownership" as well as hidden equity ownership, and perhaps morphable debt ownership as well. Third, decoupling facilitates the reemergence of a takeover technique—the "street sweep"—which appeared briefly in the 1980s, threatened to undermine U.S. tender offer regulation, and then disappeared when the poison pill defense emerged. This pattern—"the new street sweep"—has already occurred in Europe.

Part VI concludes. A related finance-oriented paper offers a more systematic and extended analysis of debt decoupling and introduces hybrid debt-equity decoupling.

I. SHAREHOLDER AND CORPORATE DECOUPLING

A. Decoupling: Overall Picture

At the core of the governance of the publicly held corporation is the shareholder vote. That governance, for the vast majority of companies, is based on a proportional relationship between voting power and economic ownership: one share, one vote.

The linkage of voting rights and economic interest serves several goals. It places the power to oversee company managers with those who have an incentive to exercise that power to increase firm value. The more shares owned, the greater the incentive and thus the greater the number of votes. Beyond the instrumental role of voting, the concept of shareholder-as-owner-and-voter is a core ideological

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basis for managerial exercise of authority over property the managers do not own.\(^5\)

This linkage also underlies most regulation of the rights and obligations of shareholders. With limited exceptions, the rules governing public firms—including state and federal corporate, securities, and other laws, federal securities rules, and stock exchange rules (collectively, "corporate governance rules")—presume that ownership of shares is a meaningful concept and conveys a standard package of shareholder rights. Some of these rights are directly economic, including dividend, liquidation, and appraisal rights under corporate law, and gain (loss) from an increase (decrease) in trading prices. We call this package of rights "economic ownership." Some rights are not purely monetary, including voting rights, director fiduciary duties, rights to bring suits and inspect corporate records, and so on. The special case of record ownership of shares by banks and broker-dealers is handled by obscure rules governing record owners, which partly reconnects economic rights with voting and other rights. Some corporate governance rules are based on formal record ownership; some are based on who holds voting rights. However, most of these rules regulate, lightly or not at all, persons who have economic ownership but not voting rights.

Over the course of the last century, all this sort of worked. The underlying assumption of a linked set of economic, voting, and other rights ("full ownership") was mostly satisfied. The special rules for record owners sort of handled the most important exception. When gaps appeared, as they sometimes did, perhaps a tinkering fix was applied, or perhaps the breakdown was simply ignored.

This underlying assumption works no longer. The derivatives revolution in finance, the growth of sophisticated, lightly regulated hedge funds, and the related growth in the share lending market now make it easy to decouple voting rights from economic ownership. Economic ownership can be further decomposed. For instance, appraisal and dividend rights can be decoupled from other economic rights. Other types of equity decoupling are possible as well, if the need arises. We focus here on the decoupling of voting rights from

\(^5\) We seek throughout this Article to limit overlap with Decoupling I. We indicate in occasional footnotes, including this one, where to find further discussion of points addressed there. Unless there is specific need, we do not repeat citations that appear there or decoupling examples discussed there. On the goals served by linking voting and economic rights, see Hu & Black, Decoupling I (Law Review Version) (2006), supra note 1, at 850-54.
economic ownership. We return to other types of equity decoupling in Part V.A.

One concern raised by decoupling is that an investor can have a large voting stake, yet a zero or even negative stake in the company's welfare. In March 2006, for example, Multi-Fineline Electronix (M-Flex), a Delaware company, offered to buy a Singapore company, MFS Technologies (MFS). WBL, another Singapore company, owns a majority stake in both M-Flex and MFS. Under M-Flex's charter, the offer required approval both by a majority of all shares and by a majority of M-Flex's minority shareholders. M-Flex set up a special committee to consider whether the acquisition was good for M-Flex's minority shareholders; the committee decided it was not and recommended that the minority shareholders vote against the acquisition. M-Flex then sued WBL, seeking to compel WBL to vote against the acquisition based on WBL's fiduciary duty as a controlling shareholder. M-Flex claimed that this was necessary because Stark, a hedge fund, held at least 48% of the minority M-Flex shares and had an incentive to vote for the offer even if it was bad for M-Flex. Stark owned a large stake in the target, MFS, and had hedged most or all of its interest in M-Flex. It would therefore be happy if M-Flex overpaid for MFS.

In the terminology we developed in Decoupling I (terms defined there are in italics), Stark had voting ownership of M-Flex shares, but zero (or nearly zero) economic ownership. Stark was thus engaged in empty voting: its shares had voting rights, but had been emptied of the economic ownership that customarily accompanies those rights. In-

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6 This discussion is based primarily on the M-Flex complaint against WBL, in the Delaware Court of Chancery, and a court order in the U.S. District Court for the Central District of California dismissing a different M-Flex complaint against Stark. See Complaint for Declaratory and Injunctive Relief, Multi-Fineline Electronix, Inc. v. WBL Corp., No. 2482-N, 2006 WL 4781677 (Del. Ch. Oct. 17, 2006); Order Granting Defendants' Motion To Dismiss First Amended Complaint, Multi-Fineline Electronix, Inc. v. Stark Master Fund Ltd., No. 06-0960 (C.D. Cal. Dec. 4, 2006). We have assumed that M-Flex's factual allegations are correct. For subsequent developments, see Sarah Tolkoff, Freed from Deal, M-Flex Seeks To Diversify, ORANGE COUNTY BUS. J., July 2, 2007, at 3 (describing M-Flex's future after WBL shareholders voted against the merger with M-Flex); and Multi-Fineline Announces WBL Shareholders Vote Against Accepting the MFS Technology Offer, REUTERS, June 26, 2007, available at http://www.reuters.com/article/inPlayBriefing/idUSIN20070626083553MFLX20070626 (discussing the WBL shareholder vote against the merger).
deed, including its position in MFS, Stark likely had a negative overall economic interest in M-Flex, and would gain if M-Flex overpaid for MFS.\(^7\)

The opposite pattern is also common—investors can use cash-settled equity swaps and other cash-settled equity derivatives to obtain economic ownership without voting rights (call these “economic only” positions). A central reason for doing this is that large shareholder ownership disclosure requirements are usually based on voting ownership; physically settled derivatives, which convey rights to obtain shares, might count, but economic ownership through cash-settled derivatives generally does not count. By shedding voting rights, hedge funds and other outside investors can avoid disclosing their positions.\(^8\)

These economic-only positions thus result in hidden ownership—economic ownership that is not disclosed, even though it would be disclosed if held directly through shares.\(^9\)

Equity swaps and other OTC derivatives—individually negotiated, customized contracts typically entered into by investors with derivatives dealers—offer opportunities that go beyond merely creating economic-only ownership.\(^10\) They also make possible morphable voting ownership. Assume that an investor takes the long side of an equity swap, and thus receives the economic return on shares from the dealer, who takes the short side. The dealer will typically hedge its exposure, often by holding “matched shares,” so that gain (loss) on the matched shares offsets loss (gain) on the equity swap. Without more, the dealer is now an empty voter—it has voting rights but no economic interest. The investor is, let us assume, a hidden owner—putting aside the potential for morphable voting rights, it has economic-only ownership, no voting rights, and thus generally no disclosure obligation.

Suppose now that the investor later wants to vote. Under common market practices, it can usually return to the dealer, unwind the swap, obtain the matched shares, and, presto, the investor has voting rights to accompany its economic ownership. Or perhaps, as sometimes oc-

\(^7\) Readers familiar with Decoupling I will recognize that the M-Flex/Stark/MFS pattern here is closely analogous to the Mylan/Perry/King Pharmaceuticals pattern discussed there.

\(^8\) We discuss the disclosure requirements for cash-settled derivatives in Hu & Black, Decoupling I (Law Review Version) (2006), supra note 1, at 864-75.

\(^9\) References in the remainder of this Article to equity swaps and other equity derivatives are to cash-settled derivatives, unless otherwise specified.

\(^10\) As to the distinction between exchange-traded derivatives and OTC derivatives, see Henry T. C. Hu, Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism, 102 YALE L.J. 1457, 1464-65 (1993).
curs in the U.K., the investor can ask the dealer to vote as it would have voted. In Decoupling I, we called the combination of hidden ownership and likely informal ability to obtain voting rights “hidden (morphable) ownership.” Both hidden and disclosed economic-only ownership may convey informal, morphable voting rights.

If the investor had clear rights to unwind the swap and obtain shares, or to instruct the dealer on how to vote, the investor would be considered to have voting rights under Securities Exchange Act of 1934 (Exchange Act) section 13(d), and would have to disclose ownership on Schedule 13D. But as long as the investor’s voting rights are implicit and not enforceable, current practice generally supports nondisclosure.

Hedge funds and other outside investors can use hidden ownership to build up large, otherwise disclosable positions, yet disclose their ownership only when they are ready. For example, in May 2007, hedge funds SAC Capital Advisors and Jana Partners claimed they were TD Ameritrade’s largest economic owners, with a combined 8.4% economic interest—without making any public filings. Atticus Capital, another prominent hedge fund, told the Wall Street Journal that it routinely uses derivatives in order to avoid disclosure, which would tip off competitors to its activities. Atticus used equity swaps and other OTC derivatives to acquire large stakes in Phelps Dodge in 2006 and Freeport-McMoran in 2007.

B. Functional Elements and Terminology

Because of the many ways in which decoupling can occur, it is useful to set out its functional elements and specify some terminology. We do so here, while being intentionally brief for elements described in Decoupling I. By “formal voting rights,” we refer to the legal right to

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13 Our discussion of TD Ameritrade is based on Gaston F. Ceron, Ameritrade Gets Pressure from Funds for a Merger, WALL ST. J., June 6, 2007, at C3; Kaja Whitehouse, David Enrich & Mara Lemos Stein, Activist Hedge Funds Use Derivatives To Target Larger Prey, DOW JONES NEWS WIRES, July 11, 2007; and TD Ameritrade Holding Corp., Current Report (Form 8-K), at 1 (June 5, 2007).
14 Gregory Zuckerman, Concentration Proves Winner at Hedge Fund, WALL ST. J., May 14, 2007, at Cl.
vote shares under company law (as supplemented by rules governing voting of shares held by record owners in "street name"), including the legal power to instruct someone else how to vote. Thus, in the common situation where a broker holds shares in street name for a customer, the customer has formal voting rights because it has the right under stock exchange rules to instruct the broker how to vote the customer's shares. By "voting rights" or "voting ownership" of shares, we refer to either formal or informal rights to vote shares, including the de facto power to instruct someone else how to vote. The company at which voting takes place is the "host company."

By "economic ownership," we will generally refer to the economic returns associated with shares. Strictly speaking, economic ownership includes related rights, such as those associated with appraisal. This ownership can be achieved directly by holding shares. Appraisal and other related rights aside, economic ownership can also be achieved indirectly by holding a "coupled asset" that conveys returns that relate directly to those on the shares. Economic ownership can be either positive (the same direction as the return on shares), or negative (the opposite direction from the return on shares).

Someone who owns voting shares has "full ownership": he has all of the rights and obligations associated with shares, including voting rights and economic rights. Putting aside the other rights we discuss in Part V, one can think of full ownership as consisting of voting ownership plus direct economic ownership. But it is also possible to decouple these two rights and have voting-only ownership or economic-only ownership. Economic-only ownership may or may not be hidden (i.e., exempt from the disclosure rules that would apply to full ownership, and not voluntarily disclosed), and may or may not be accompanied by morphable voting rights.17

Decoupling voting and economic rights often depends on combining full ownership of shares with ownership of a coupled asset. Coupled assets include derivatives (such as options, futures, and eq-

16 See infra Part V.A. Nothing in the framework presumes that shareholder rights in general—or shareholder economic rights—are limited to those that would be possessed by a residual claimant. For discussion of the limitations of the "residual claimant" notion in characterizing shareholder rights, see Hu & Westbrook, Shareholder and Creditor Interests (2007), supra note 3, at 1382-89, 1393-98.

17 Economic-only ownership, accompanied by morphable voting rights, is not truly "economic-only." We judged that this imprecision did not justify creating yet another term for this type of ownership, which would fall in between economic-only and full ownership.
uity swaps), contractual rights (such as rights under a share loan agreement), and other financial products, which convey an economic return that relates directly to the return on shares. The coupled asset affects economic ownership, but leaves voting rights unchanged. In principle, one could also decouple voting and economic rights by holding shares and having a side contract relating to the votes, but this is not common in practice. By “net economic ownership,” we refer to a person’s combined economic ownership, based on both host shares and coupled assets. The level of net economic ownership may depend on share price. For example, if a company’s shares trade at $50, and an executive has a collar that caps upside at $60 and downside at $45, the option “deltas” (and thus the executive’s economic exposure to share price changes) depend on share price.

We refer to anyone who has substantially greater voting than economic ownership as an “empty voter.” Voting can be partially or fully empty. For example, an executive who hedges economic exposure to the company’s shares with a zero-cost collar will often be—depending on the executive’s securities and stock option holdings—a partially empty owner. We similarly refer to anyone who has substantially greater economic than voting ownership, where that extra ownership falls outside ownership disclosure rules, as a “hidden owner.” If the hidden owner likely has effective access to voting rights when needed, he has “hidden (morphable) ownership.”

Hidden (morphable) ownership can also be seen as one form of “soft parking” of shares: shares held in friendly hands to avoid regulatory or other burdens of direct ownership, yet providing access to the desired shareholder rights. Here is a soft definition of soft parking of shares. One party (the “parkee”) holds shares and thus apparent voting rights, but limited or no economic ownership. The parkee is informally expected to either (1) vote as another party (the “parker”) would want, or informally requests, or (2) arrange, if the parker requests, to unwind the parking transaction and return the voting rights to the parker. The parkee will often be a derivatives dealer or bank. The parker could be an outside shareholder, an insider, or a corporation. If a corporation or its insiders are the parker, the parked shares will often be the corporation’s own shares, but could be shares of a subsidiary or transaction counterparty. Economic ownership corresponding to the parked shares will often but not always reside with the parker. In corporate decoupling, for example, the company may have effectively repurchased its own shares; there will then be no true economic owner.
Soft parking can serve a number of purposes, including: (1) letting the parker avoid disclosure of economic ownership, voting ownership, or both; (2) especially for corporate decoupling, ensuring that shares retain voting rights, which they might lose in the parker's hands; (3) avoiding other regulatory requirements, such as mandatory bid rules; and (4) tax arbitrage, if dividends or other cash flows on shares are more lightly taxed for the parkee than for the parker. Its boundaries are fuzzy. As informal expectations on how the parkee will act become firmer, and potentially enforceable, soft parking shades into hard. As the parkee's economic ownership increases, the parking analogy loses it force.

Investors may also hold "related non-host assets"—assets, often securities of another company, whose value is related to the value of the host company's shares. For example, if the host company plans to acquire a target in a share-for-share merger with a fixed exchange ratio, the target's shares are a related non-host asset. The combined return from host shares, coupled assets, and related non-host assets produces an "overall economic interest" in taking actions that affect firm value, which can be positive, zero, or negative.

Empty voting, as we have defined it, includes some longstanding arrangements for concentrating voting power. These include dual-class capital structures, with one class holding greater voting power relative to economic rights, and pyramids and circular ownership structures, which concentrate effective voting control in the hands of the person, family, or group at the top of the pyramid or the "center" of the circular ownership structure. The implications and regulation of these techniques are beyond the scope of this Article.18

More subtly, one might see proxy voting advisors, such as Institutional Shareholder Services (ISS), as empty voters as well. These advisory services have no direct economic interest in shares, yet wield substantial voting power through their advice to institutional investors. Voting advisors may also have conflicts of interest (e.g., ISS and its affiliates sell services to both investors and companies). ISS's advice reaches investors controlling $25 trillion in equities, and about 25% of those investors routinely cast their votes according to ISS guidelines. Case-by-case exceptions are possible but not common.19 Thus, ISS and

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18 We discuss these techniques in Hu & Black, Decoupling I (Law Review Version) (2006), supra note 1, at 858-59.

19 Joe Bacchus, Rockville-Based Corporate Governance Firm To Merge with RiskMetrics, DAILY RECORD (Baltimore), Nov. 2, 2006, available at 2006 WLNR 19183261; Robert D.
other voting advisors, as a practical matter, have significant voting ownership, but no economic ownership. But they are empty voters only at the sufferance of their principals. Analysis of ISS and other voting advisors as empty voters is also beyond our scope.

C. Shareholder Rights: Empty Voting

1. Hedge Funds and Other Shareholders

Hedge funds and other outside shareholders largely accomplish empty voting through the use of coupled assets (such as equity derivatives or stock loan agreements), as well as through related non-host assets. Since we have detailed these strategies in Decoupling I, we touch on their mechanics only lightly.

One core strategy for empty voting is to hold shares but hedge the economic return on the shares, such as through a short equity swap position, buying put options (or selling call options), or a short position on a single stock future. Absent a major change in doctrine, the strategy of equity derivatives as coupled assets would not run afoul of corporate law rules limiting vote buying.

Corporate law seeks to limit the decoupling of economic interest and voting power through the classic common law prohibition on "vote buying," defined to be the transfer of a shareholder's voting rights, shorn of empty economic interest, to a third party. The current Delaware attitude is more tolerant. In the leading 1982 case of Schreiber v. Carney, the court held that each vote buying arrangement "must be examined in light of its object or purpose"; vote buying was permitted if it satisfied a test for intrinsic fairness. As under the common law, Delaware considers vote buying to involve a vote seller who transfers the voting rights to a vote buyer.

Hershey, Jr., A Little Industry with a Lot of Sway on Proxy Votes, N.Y. TIMES, June 18, 2006, § 3, at 6.


21 447 A.2d 17 (Del. Ch. 1982).

22 Id. at 25.

23 Id. at 26.

24 More specifically, Schreiber defines vote buying as "a voting agreement supported by consideration personal to the stockholder, whereby the stockholder divorces his discretionary voting power and votes as directed by the offeror." Id. at 23.
A new vote buyer using equity derivatives can acquire voting rights through a two-step process in which neither step involves a transfer of voting rights: first, purchase shares; and second, shed the economic interests associated with those shares. The share purchaser is left holding only the voting rights associated with the shares.

Consider the Stark/M-Flex situation. Stark purchased M-Flex shares and entered into equity derivatives, which hedged its economic exposure. Neither step involved either a vote seller or a transfer of voting rights. Instead, these transactions involved a share purchaser and a transfer of economic interests. The decoupling is achieved by two normal market transactions—a share purchase and a hedging transaction—rather than a single suspect purchase of votes.

An alternate empty voting strategy is known as record date capture. (Below, we refer to the voting record date simply as the “record date,” except when we need to distinguish the voting record date from the dividend record date.) This strategy involves borrowing shares in the stock loan market just before the record date and returning the shares immediately afterwards. Under standard borrowing arrangements, the borrower has no economic exposure to the company. The borrower contracts with the share lender to (1) return the shares to the lender at any time at the election of either side, and (2) pay the lender an amount equal to any dividends or other distributions the borrower receives on the shares. Taxes aside, this loan agreement (a “coupled asset” in our framework) leaves the borrower holding votes without economic ownership, while the lender has economic ownership without votes.

Stock borrowings originally developed to facilitate short selling. The borrower sells the borrowed shares and ends up with negative economic ownership and no voting rights. The buyer of the sold-short shares has full ownership; the share lender has economic-only ownership. Decoupling still exists, but there is no empty voter. But omit the short sale, and stock borrowing becomes a vehicle for empty voting.25

A subtle yet central aspect of these empty voting strategies is that they do not directly require market trading of shares. Thus, they can often be carried out, rapidly and on a large scale, with little impact on share price. Consider the share borrowing strategy. The empty voter borrows shares, and votes simply move from the share lender to the empty voter. No shares are bought or sold. This strategy will affect

25 As discussed infra in Part IV.C, there are bank regulatory and other limitations on borrowing shares for voting purposes in certain circumstances.
the shares' trading only if the borrowing is on a scale which affects the ability of short-sellers or hedgers to ply their trade. More complex alternatives can also produce little or no direct impact on share trading. Consider the strategy (buy shares, hedge with equity swaps). An empty voter can buy shares from a dealer and simultaneously take the short side of an equity swap with the same dealer. The dealer will want to hedge. A direct way to do so is to borrow the shares (with no share trading) at the same time it creates the swap. The empty voter ends up with hedged share ownership, the dealer is hedged as well, and votes have again moved from the share lender to the empty voter, without either the investor or the dealer having bought or sold any shares. The equity swap transaction itself is private and undisclosed.

The borrowing directly affects the share lending market, but for most companies, at most times, this market includes a large pool of borrowable shares, available at a quite modest price, on the order of 20 basis points per year.\(^26\) One constraint on the scale of these approaches is the number of shares that can be readily borrowed. Hard numbers are not available, but a conservative estimate is that for most large U.S. public companies, at most times, 20% or more of the outstanding shares can be readily borrowed.\(^27\)

Empty voters can, of course, trade shares between the record and voting dates. In some cases, their voting position will let them profit from this trading. Efforts to model the efficiency properties of empty voting are only beginning, but one recent model suggests that this ability to trade can sometimes be efficiency enhancing, and sometimes not.\(^28\)

2. Soft Parking by the Corporation Itself

In *Decoupling I*, we discussed how both outside and inside shareholders can engage in empty voting. Two of our examples involved corporations themselves doing so, but we did not analyze this systematically. In hindsight, we should have done so. In fact, corporations can use decoupling techniques to allow insiders or other friendly third parties to vote shares with partial or no economic exposure. Often the goal is to ward off changes in control. In doing so, corporations are

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\(^27\) We discuss the size of the share lending market *infra* in Part IV.C.1.

doing indirectly what corporate law forbids doing directly—owning and voting the company's shares in itself. Corporations can also use a hedged position in another company to influence the outcome of a takeover bid or other major transaction.

Most strategies for corporate empty voting are variants on the soft parking theme we discussed above for hidden (morphable) ownership. Company insiders arrange for voting ownership to be held by someone else, and ensure that the someone else has incentives to vote pro-management. Usually, the voteholder is not formally obliged to vote as management directs—that would invite disallowance of the votes under corporate law. Incentives and informal understandings do the work instead. The corporation can soft park their shares with a variety of people, in a variety of ways. A nonexhaustive list of examples includes equity swaps, forward transactions, share loans to trustworthy stock borrowers, ESOPs, and issuance of restricted shares. We discuss these in turn.

One strategy involves the corporation acquiring economic ownership of its shares through an equity swap or other equity derivative contract with a derivatives dealer or other professional friend. In substance, the corporation has repurchased its own shares. But the shares remain outstanding and votable. By whom?

The dealer, in all likelihood. The dealer will be short on the swap. It can hedge its economic risk by holding matched shares, much as if it entered into a similar swap with an outside investor. The structure of this transaction is the same as the hidden ownership structure we discussed above for outside shareholders—except that, unlike an outside shareholder, the corporation should be seen as having repurchased its shares, rather than being an economic owner. Formally, a corporation's own shares, when owned by the corporation, are no longer considered to be outstanding. If the dealer will vote as directed by the corporation, the corporation can be seen as an empty voter, with hidden, morphable voting rights. The dealer becomes the corporation's voting agent. The transaction could well be large; the principal limit is the corporation's financial ability to repurchase its own shares.

The dealer's incentives to vote as its client would want are similar to the hidden ownership scenario. The dealer wants to stay on good

terms with this client and preserve a reputation for treating clients well. The incentives that give outside investors morphable voting rights are the same or perhaps stronger. The dealer will presumably understand that the company is acquiring swaps rather than shares for the purpose of leaving votes in friendly hands. The dealer would frustrate the transaction's purpose if it were to either hedge with anything but matched shares, or fail to vote as its client wants. A further factor is the dealer's need to sell the matched shares when the swap expires; this can be especially important if the shares are thinly traded or the swap is related to a sizeable block of shares. The company will be the most likely and sometimes the only plausible purchaser of the shares. By voting against management, the derivatives dealer could undermine its ability to unwind the transaction—and for what? The dealer has no economic stake in the company and doesn't really care how the vote comes out.

This soft parking strategy has advantages over two similar defensive strategies sometimes used by companies to defend against outside attacks: stock buybacks and sale of shares to a "white squire." As with a stock buyback, the company's share price may increase, making the outside bid less attractive. But, unlike a stock buyback, the purchased shares can be voted. Suppose, for example, that insiders control 25% of a company's shares. A buyback of another 20% will leave them owning 25%—a stronger but not impregnable position. Soft parking of another 20% will give them 40% of the votes, and thus come much closer to full control.

An alternative is to place stock directly into friendly hands: a so-called "white squire" who is expected, and sometimes contractually required, to support management, at least for a period of time. However, here too, soft parking can have advantages. First, it is quick. It takes time to identify, negotiate, and consummate a transaction with a white squire, and the effort might fail altogether. Second, the white squire transaction is more likely to require public disclosure. Third, the New York Stock Exchange generally requires shareholder approval for a company to issue more than 20% of its shares in this context, so


31 We discuss the disclosure rules that apply to soft parking infra in Part III.C.
white squire transactions typically remain below this threshold.\textsuperscript{32} There is no comparable shareholder approval rule for derivatives transactions. Finally, white squires may not remain faithful.

There are potential risks to this strategy. First, shares in the hands of the derivatives dealer could be deemed akin to shares in the hands of a subsidiary or other entity controlled by the corporation, in which case they could not be voted.\textsuperscript{33} But this issue has not been litigated and the applicability of these analogies is far from clear.\textsuperscript{34} Second, takeover defenses are subject to judicial scrutiny. The likely standard of review would be that of \textit{Unocal Corp. v. Mesa Petroleum Co.} and \textit{Unitrin, Inc. v. American General Corp.} Under the \textit{Unocal} test, as refined in \textit{Unitrin}, a defensive action cannot be coercive or preclusive, and must otherwise fall within a range of reasonableness as a response to a perceived threat.\textsuperscript{35} A change of control transaction must meet the stricter standard of \textit{Revlon, Inc. v. MacAndrews \& Forbes Holdings}, but the informal nature of soft parking, even if it conveys effective control, might well let it escape \textit{Revlon} scrutiny.\textsuperscript{36}

We are not yet aware of U.S. corporations employing this equity-swap strategy, but it is used in Europe. We are aware of one major derivatives dealer using PowerPoint outlines to market such strategies to European corporations. In addition, an effort to park treasury shares with a dealer (Barclays Bank) formed part of Portugal Telecom's successful defense against a 2006 takeover bid by its smaller rival, Sonae-

\textsuperscript{32} NYSE Euronext, Listed Company Manual § 312.03(c) (2007).

\textsuperscript{33} On voting of shares held by a subsidiary or otherwise controlled by the corporation, see James D. Cox, Thomas Lee Hazen & F. Hodge O'Neal, CORPORATIONS §§ 13.16, 21.7 (1997). The risk of the shares losing voting power might increase if the corporation were to bind the dealer contractually to hedge through matched shares, to ensure that the dealer retained voting rights.

\textsuperscript{34} Similar issues have been litigated in New Zealand and Australia, with regard to whether morphable economic ownership was covered by large shareholder disclosure rules. In both countries, appellate courts ruled that disclosure was not required. See Hu & Black, \textit{Decoupling I (Law Review Version)} (2006), \textit{supra} note 1, at 836-37 (Perry-Rubicon) and 840 (Glencore-Austral Coal).


\textsuperscript{36} See Revlon, Inc. v. MacAndrews \& Forbes Holdings, 506 A.2d 173, 180 (Del. 1986) (requiring close judicial scrutiny of transactions which result in a change of control, often referred to as "\textit{Revlon}" scrutiny).
As part of its defense, the board of Portugal Telecom also offered to spin off its affiliate, PT Multimedia. A press report noted that Portugal Telecom held 58% of PT Multimedia's shares directly and "controls also another 10 pct, which are in the hands of British Barclays, in the scope of two 'equity swap' contracts."38

Other variations on the soft parking theme are also possible. A simple forward transaction with a friendly shareholder can also do. Consider the 1994 proxy fight between the Union Bank of Switzerland (UBS) and activist Martin Ebner.39 UBS reportedly entered into forward contracts with two large shareholders, under which UBS would buy these shareholders' UBS shares soon *after* a critical stockholders' meeting. The economics were equivalent to an immediate repurchase of shares, plus a short-term loan from the sellers to UBS. However, the voting rights remained with the sellers, at least one of which was expected to vote as UBS wanted.40

Several additional soft parking strategies are based on the use of "treasury shares"—shares that a company has repurchased, which it cannot directly vote. The company can either (1) "sell" the shares to a friendly dealer, while taking back an equity swap or otherwise protecting the dealer against loss; or (2) simply lend the shares to a friendly holder. Consider share lending. The borrower would be an empty voter, serving as the agent of the corporation. There are no cases on point, but as long as the borrower is not contractually bound to vote as the lender's management wishes, its votes might well count. We as yet

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37 Our discussion of Portugal Telecom is based on information provided by knowledgeable Portuguese investment bankers and lawyers. See also Lisbon Shares Lower Midmorning Led by Telecoms Ahead of Portugal Telecom EGM, AFX INT'L. FOCUS, Mar. 2, 2007 (stating that "PT management also intends to use 1.8 pct of the company's shares held by Barclays Bank to vote at the EGM [Extraordinary General Meeting] today").


39 Our discussion relies on Claudio Loderer & Pius Zgraggen, When Shareholders Choose Not To Maximize Value: The Union Bank of Switzerland's 1994 Proxy Fight, J. APPLIED CORP. FIN., Fall 1999, at 91.

40 By way of comparison, U.S. companies sometimes enter into forward purchases of their own shares to hedge obligations under employee benefit plans. See Jim Rothwell, Common Derivatives and Their Uses—Equity Derivatives, in SWAPS AND OTHER DERIVATIVES IN 2006, at 51, 73 (PLI Corp. Law & Practice, Course Handbook No. B-1559, 2006). No one has suggested that the counterparty loses voting rights.
know of no significant U.S. examples, but this form of soft parking has been used a number of times in Europe.

In the summer of 2007, OMV, an Austrian oil and gas firm, raised its stake in its Hungarian competitor, MOL, from 10% to 18.6%, and soon thereafter launched a takeover bid. As a defensive measure, MOL launched a massive stock buyback program. By late August, MOL had bought back nearly half (48.8%) of its own previously outstanding shares, with 7.8% held directly and another 41% lent to two Hungarian banks. MOL spent more than $2 billion buying itself.

Decoupling played a critical part in MOL's defense. Under Hungarian law, a firm cannot vote its own shares. MOL avoided this limitation by lending most of the repurchased shares to the two banks. The banks were nominally free to vote as they wished but could not sell the shares and were widely expected to vote them as MOL management wished. OMV said as much publicly in September 2007, when it announced an offer to purchase MOL shares. OMV referred to “MOL management's effective control of shares in MOL which many in the financial markets believe now amounts to control over approximately 40% of the shares established through the use of various structural arrangements (a situation that has not been refuted by MOL).”

In the Netherlands, corporate soft parking has been common, at least until recently. One example involves the issuance of shares to a company-controlled foundation, which then sells depositary receipts


to the public. The depositary receipts are nonvoting; the public ends up with economic ownership while the foundation retains the voting rights. Dutch firms have also granted to a company foundation a call option, which the foundation can exercise to acquire shares and thus voting rights if a threat to control arises. In 2006, for example, two hedge funds acquired 31% of Stork NV. In response, the Stork Foundation exercised an option (granted in 1990) to acquire preference shares with a high ratio of votes to economic rights; the preference shares represented just less than 50% of Stork’s total voting rights. The Dutch courts disallowed the issuance.

3. Employee Stock Ownership Plans; Restricted Stock Plans

A company can also arrange for friendly votes through ESOPs and like plans, and by granting restricted shares to its executives. Employees who own shares can be expected to support management against a hostile takeover, because they fear a threat to their jobs (rightly or not). One recent study estimates that “each additional percentage point of employee ownership reduces the annual probability of takeover by 0.44 percentage points.”

How, though, does employee ownership relate to empty voting? There are two principal possibilities. Consider ESOPs first. The term covers a variety of arrangements, some subject to the Employee Retirement Income Security Act (ERISA), others not and hence offering greater flexibility. The company can simply allocate shares to em-

47 See, e.g., Block (2007), supra note 30, at 147 (“ESOP shares are likely to be voted or tendered in a manner consistent with management’s interests.”).
49 See Robert Hockett, What Kinds of Stock Ownership Plans Should There Be? Of ESOPs, Other SOPs, and “Ownership Societies,” 92 CORNELL L. REV. 865, 885 (2007); see also Theodore N. Mirvis, Takeover Law and Practice 2006, in WHAT ALL BUSINESS LAW-
ployees over time as the shares vest. If so, there would be no empty voting. But a company can also contribute a block of stock to an ESOP, with the shares to vest over an extended period. In this arrangement, all shares carry voting rights, even though employees economically own only the vested shares. There are then two common choices for how these shares are voted. In the first approach, the trustees for the ESOP decide how to vote these shares. Those trustees can be anyone, including company managers. The trustee becomes an empty voter, and will predictably vote pro-manager. This is similar to soft parking except that the structure is long term and the shares will eventually vest in employee hands.

In the second approach, the ESOP trust agreement provides that unvested shares will be voted proportionately to the votes cast by employees with respect to vested shares, and perhaps that unvested shares will be tended into a tender or exchange offer in the same proportion as vested shares. Here the employees are partially empty voters—they have more voting power than economic ownership. The Department of Labor has found proportional voting to be reasonable under ERISA.

"Leveraged" ESOPs, which have more total shares than vested shares, have long been used as a takeover defense, though perhaps less often once poison pills became the dominant defense. One notable example was NCR Corporation’s (NCR) attempt to defeat a takeover by AT&T in 1991. NCR’s board responded to the AT&T bid by adopting an ESOP which held 8% of NCR’s total votes; each employee received 1 vested share and 228 unvested shares, which would vest over the next 25 years. The effort failed; the Ohio court found that the adoption of the ESOP was "not related to benefits objectives but, rather, was an attempt to place as large a number of shares into friendly hands as possible."

YERS & LITIGATORS MUST KNOW ABOUT DELAWARE LAW DEVELOPMENTS 2007, at 147 (PLI Corp. Law & Practice, Course Handbook Series No. B-1599, 2007) (describing various plans designed to encourage employee ownership of stock, including non-ERISA Stock Employee Compensation Trusts).


Id. at 482.
Some additional examples follow. In the United States, as with any takeover defense, the creation or expansion of an ESOP will be judged under the *Unocal* standard, discussed above for soft parking.\(^5\) Some were allowed by the courts; others were not.

- In 2002, Quanta Services adopted an ESOP in response to Aquila’s takeover attempt.\(^6\)
- In 1999, in response to LVMH’s acquisition of 34% of the outstanding shares of Gucci, Gucci established an ESOP and issued an equal number of shares to it.\(^7\)
- In 1989, Dunkin’ Donuts created an ESOP to respond to a possible hostile takeover bid by Kingsbridge Capital Group.\(^8\)
- In 1988, Polaroid adopted an ESOP involving 14% of its shares in response to a takeover bid by Shamrock Holdings.\(^9\)
- In 1988, Macmillan attempted (unsuccessfully) to fend off Maxwell Communications by, among other things, contributing shares to an existing ESOP and replacing the trustee with members of management.\(^10\)

A second possibility for empty voting arises from grants of restricted shares, often principally to managers and key employees.\(^11\) The shares are “restricted” because they vest over time, typically several years; unvested shares are usually forfeited if the employee leaves.\(^12\) Both vested and unvested shares usually carry voting rights.\(^13\)

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5. See supra note 35 and accompanying text.
6. *Aquila, Inc. v. Quanta Servs., Inc.*, 805 A.2d 196, 199-202 (Del. Ch. 2002). The Chancery Court concluded that Quanta’s decision to create the ESOP would likely not satisfy the second prong of the *Unocal* test for defensive tactics, that of a proportionate response to the threat posed by the Aquila bid. *Id.* at 207-08.


11. *See Brad J. Schwartzberg & Evan Weiner, Attracting and Retaining Key Employees by Offering Equity-Based Incentive Compensation*, METROPOLITAN CORP. COUNS., June 2007, at 44.

12. *See Janice Kay McClendon, Bringing the Bulls to Bear: Regulating Executive Compensation To Realign Management and Shareholders’ Interests and Promote Corporate Long-Term*
Thus, the recipient has more voting rights than economic interest, leading to partially empty voting. As restricted stock plans grow in popularity relative to stock options, these plans could become a significant source of empty voting.

4. Empty Voting of Another Company’s Shares

A further possibility involving corporate empty voting involves two firms whose fortunes are linked in some way—acquirer and target are the most obvious possibilities. First, any time an acquirer needs a shareholder vote to complete an acquisition, the target and its shareholders may try to influence the acquirer’s vote by obtaining votes without accompanying economic ownership. The Perry-Mylan incident, discussed in Decoupling I, involves such an effort by a target shareholder. But targets could use similar strategies themselves, either directly or through friendly investment banks. No disclosure rules directly address this possibility, so it might well remain hidden, especially if done indirectly.

It is also possible for the acquirer or its shareholders to buy target votes. In Decoupling I, we described the effort of Sears Holding to influence the votes on shares of its Sears Canada subsidiary, ostensibly held by minority shareholders, in order to obtain the majority-of-minority approval it needed under Canadian law to complete a freezeout. In Germany, Lindner Holding sought in 2006 to use borrowed shares in a subsidiary to reach the 95% threshold under Ger-

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The extent of empty voting by executives who receive restricted shares will depend on, among other things, the recipient’s expectation that he will likely stay through the vesting period and the possibility that the recipient also holds employee stock options (which convey economic ownership without voting rights) and hence may not be an empty voter based on the recipient’s full position.


Id. at 839.
man law needed to complete a freezeout. The German courts did not allow the borrowed shares to count toward the threshold.\footnote{We thank Professor Dr. Theo Baums for providing information on this case. See Oberlandesgericht München [OLG München] [Munich Court of Appeals] Nov. 23, 2006, 2006 Zeitschrift für Wirtschaftsrecht [ZIP] 2370 (F.R.G.) (German decisions do not include party names).}

More generally, activist shareholders fairly often oppose buyouts and freezeouts, seeking a higher price. Do some acquirers, when facing active opposition, directly or indirectly buy some target votes, using one or more of the strategies we have outlined? Do deal opponents sometimes buy votes? Rumors swirl, but no one knows for sure how often this happens.

The recent high-profile takeover battle for ABN Amro offers a twist on these scenarios. There were two bidders: Barclays (U.K.) and a consortium of Fortis (Belgium), Royal Bank of Scotland, and Santander (Spain).\footnote{Our discussion of ABN Amro is based primarily on Louise Armitstead, Dutch Options Riddle, SUNDAY TIMES (London), July 22, 2007, § 3, at 2; Jane Croft, Fears that Hedge Funds Are Out To Block Fortis, FIN. TIMES (London), July 27, 2007, at 22; Steve Goldstein, ABN Amro Declares Neutrality on Buyout Offers, DOW JONES BUS. NEWS, July 30, 2007; Carrick Mollenkamp, Fortis Borrowing Surges: Backers, Opponents Work Toward Position To Influence Vote, WALL ST. J. EUR., July 27, 2007, at 18.} Fortis needed shareholder approval to issue shares to finance its part of the consortium's bid. Some traders believed that ABN Amro borrowed Fortis shares so it could vote against the financing. One trader reported receiving an "unlimited borrow" request by ABN Amro for Fortis shares, and said that Fortis borrowing levels "went through the roof."\footnote{Armitstead (2007), supra note 69.} ABN Amro denied that it was borrowing Fortis shares on its own behalf. The true facts are unclear, but it seems likely that many investors borrowed Fortis shares in order to vote on the financing.

D. Shareholder Obligations: Avoiding Disclosure

1. Outside Shareholders

Thus far, we have focused primarily on how decoupling has affected shareholder rights, most notably voting rights. Decoupling can also affect shareholder obligations, such as the obligation to disclose large ownership stakes. The United States and many other countries require large shareholder disclosure, in various forms.\footnote{We discuss the U.S. rules in Hu & Black, Decoupling I (Law Review Version) (2006), supra note 1, at 867-75.} These disclo-
sure rules often depend on possession of voting rights beyond specified thresholds. Thus, in the United States, a 5% (voting ownership) shareholder must file a Schedule 13D or 13G, and all institutions must report their shareholdings quarterly on Form 13F. Physically settled derivatives count toward the 13D/13G threshold, but cash-settled derivatives do not. In contrast, economic-only ownership usually does not count toward triggering disclosure, and may not need to be disclosed even if a filing is otherwise required. 72

This leads to a simple avoidance strategy, which we discuss in Decoupling I and summarize above: an investor can hold economic-only ownership, through equity swaps or other derivatives. As we discussed above, this ownership is often morphable—the investor has no official voting rights, but can acquire them, to high probability, when needed.

2. Insiders

In contrast to outside shareholders, insiders—directors, officers, and 10% shareholders of U.S. public companies—generally cannot use decoupling to avoid disclosing their economic ownership stakes. These persons are subject to disclosure requirements under Exchange Act section 16. Section 16, in contrast to Schedule 13D, Schedule 13G, and Form 13F, focuses on economic ownership, and will thus capture equity swaps and other equity derivatives, whether physically settled or cash-settled. 73

Decoupling can, however, be helpful in two ways. First, for 10% shareholders, the reporting obligation includes economic ownership, but the 10% ownership threshold is based on the same concept of beneficial ownership used in Schedule 13D, which focuses on voting power. Thus, a large shareholder can avoid becoming covered by section 16 by holding equity swaps instead of shares. Second, the disclosure is on an obscure filing—it may well be buried in the flurry of insider ownership reports under Section 16. There can be dozens or hundreds of such reports per firm per year. Many investors rely on

73 We discuss the section 16 disclosure requirements for cash-settled derivatives in Hu & Black, Decoupling I (Law Review Version) (2006), supra note 1, at 873-74.
the firm's annual proxy statement to indicate inside ownership—yet proxy statement disclosure is again focused on voting rights. 74

3. The Corporation Itself

We have discussed above how firms can engage indirectly in empty voting. One strategy involves the firm holding equity swaps on its own shares. Here, one can see the corporation as economically having repurchased its own shares, while leaving the voting rights outstanding and in friendly hands. What is hidden is the firm's repurchase of its own shares. All else is similar to shareholder use of equity swaps to create hidden (morphable) ownership. In the share lending variant of corporate soft parking, in contrast, the company's ownership of its own shares is disclosed, but not the existence of voting rights, which are normally extinguished by a repurchase, but reappear when the company lends the shares to an outsider.

For both variants, we discuss in Part III.C.1 the rules that govern corporate disclosure. Depending on context and amount, these strategies will often fall outside the usual corporate disclosure rules, which focus on the company's transactions in its own shares.

II. REAL WORLD SIGNIFICANCE OF DECOUPLING

Is decoupling merely a curiosity? We often get this question in the United States, but seldom in Europe. We believe that there is now substantial evidence that decoupling is important and common, and that it can materially affect the control of major corporations throughout the world. Its public visibility—and perhaps its actual use—has thus far been less in the United States than in Europe. Why this is so is not clear. The techniques that work there largely will work here as well. Our investors, insiders, investment bankers, and lawyers are as clever as European ones—indeed, the investors, bankers, and lawyers are often the same firms and sometimes the same people. Perhaps U.S. market participants are better at keeping what they do hidden. Perhaps they have thus far been more cautious. Many U.S. firms have poison pill defenses, which limit the value of acquiring a large economic-only position by impeding the later acquisition of voting rights. But U.S. examples exist—and more will surely emerge.

In this Part, we provide two kinds of evidence of the worldwide importance of decoupling. First, we offer a case study of Switzerland, which illustrates decoupling's worldwide characteristics and its potential to influence takeover battles for major firms. What has happened in Switzerland can happen elsewhere, including the United States. Second, we provide a cumulative table of worldwide decoupling examples, which is greatly expanded compared to a similar table in Decoupling I.

A. Swiss Stealth Takeovers, 2005–2007

Airport novels are fun: dark intrigues, financiers wealthy beyond imagining, complex schemes, and the control of huge enterprises—if not nations—hanging in the balance. For the Swiss, much of this occurred for real in 2007. Sulzer, a major engineering firm, and other flagship corporations discovered that deep-pocketed foreign investors had secretly acquired massive stakes—32% in the case of Sulzer—with a takeover bid soon to follow. With respect to Sulzer, these foreigners—two Austrians and a Russian oligarch—had been helped by a major Swiss bank, Zurcher Kantonalbank (ZKB). Similar dramas in 2005–2007 involved Saurer, first versus Laxey Partners, a hedge fund, and later versus this Austro-Russian group (which acquired Laxey’s stake in Saurer); Ascom versus the Austrians alone (Vichty Industriebeteiligung (Victory Industrial)); Converium versus Scor (its French competitor); Implenia versus Laxey Partners; and Unaxis versus Victory Industrial. The real or imagined presence of Victory Industrial may have caused jumps in the shares of many other mid-sized Swiss industrial companies.

Let us look at these examples, which all involve hidden (morphable) ownership, starting with Sulzer. As background, at the beginning of 2007, Swiss rules required disclosure of large ownership stakes but focused on possession of voting rights. Public disclosure was required if an investor’s holdings of shares exceeded 5% of the shares. The rules also captured physically settled call options, but not cash-settled derivatives.

Sulzer/Victory Industrial-Vekselberg (2007). The Swiss business community and regulators were shocked when an Austro-Russian group

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announced it had secretly amassed a 32% stake in the engineering firm. The group proceeded to bid for and acquire Sulzer. Meanwhile, the news created an uproar resulting in the resignations of the CEO and head of investment banking at ZKB and a police raid on Deutsche Bank’s Zurich offices.\(^{77}\)

Viktor Vekselberg, a Russian oligarch and billionaire investor, and his company Renova joined forces with two prominent Austrian raiders, Georg Stumpf and Ronny Pecik, and their company Victory Holdings. Their investment vehicle, named Everest, used cash-settled call options, provided primarily by ZKB and Deutsche Bank, to amass a large stake in Sulzer. When it was ready to disclose its stake and make a bid, it unwound the swaps and obtained these dealers’ matched shares. In early 2007, Sulzer’s shares rose amid speculation that Victory was secretly acquiring shares. Finally, Everest announced in April that it owned 18% of Sulzer’s shares and held options to acquire another 14%—32% overall. ZKB then came under fire for participating in Everest’s secret build-up in ZKB’s own long-time client, Sulzer. The chief executive of ZKB and various department heads resigned or were fired. The bank’s board stated that, while ZKB would continue derivatives activity, it would not knowingly participate in hostile takeovers of the bank’s clients.

\textit{Ascom/Victory Industrial (2007) and Unaxis/Victory Industrial (2005).} Earlier in 2007, Victory announced it had acquired a 20% stake in Ascom, a Swiss electronics systems company. The stake was composed of 15% shares and 5% call options. Victory later raised its stake to 25%. Here too, Ascom’s share price rose before the announcement on speculation that Victory might make a bid. Several months later, and after Ascom’s share price had nearly doubled, Victory sold its stake to ZKB.\(^{78}\)

Victory first used decoupling strategies to build a hidden stake in 2005 at Unaxis, a Swiss technology company.\(^{79}\) Victory secretly ac-


\(^{79}\) Our discussion of Unaxis is based on Carl Mortished, \textit{Bodycote Board Rejects Fourth Takeover Approach from Sulzer}, TIMES (London), Apr. 19, 2007, at 58; Simonian (2007), \textit{supra} note 76; Simonian (2007), \textit{supra} note 78; Press Release, OC Oerlikon, Disclosure
quired a 30% stake in Unaxis using call options. Victory then re-
placed the entire Unaxis board, except the CEO, and changed the
company's name to OC Oerlikon. In July 2007, under new Swiss dis-
closure regulations, Victory announced it held 68% of Oerlikon—30%
through shares, 21% in physical-delivery call options, and 17% in vari-
ous cash-settled derivatives. The SWX Swiss Exchange is reportedly
investigating Oerlikon for possible breaches of disclosure and publica-
tion rules.

Hidden (morphable) ownership tactics were used twice with Saurer,
the Swiss machinery maker. First, hedge fund Laxey Partners an-
nounced a previously undisclosed 13% stake, through a combination
of shares and options. Laxey demanded various governance changes
and built its stake to 24%. Unaxis separately used cash-settled options
to acquire a further 21%, bought Laxey's stake, and emerged as a 45%
holder, without prior disclosure. Unaxis (now Oerlikon) then an-
nounced a tender offer for the remaining Saurer shares. The Saurer
board accepted a revised offer.

Implenia/Laxey Partners (2007). Laxey Partners again built a large
stake in a Swiss company. Laxey announced in April 2007 that it held
23% of Implenia, a construction group. The stake was likely acquired
initially through cash-settled options. Implenia asked regulators to
investigate how Laxey had built its stake without disclosure. Implenia
also refused Laxey's attempts to register Laxey’s holding of more than
4.9% of its shares, citing the Swiss Lex Koller law, which prevents for-
eigners from buying Swiss real estate. Laxey then sued Implenia and
forced Implenia into mediation. It remains to be seen whether Laxey, or someone else, will acquire Implenia.

*Converium/Scor (2007).* Scor SA, a French reinsurer, announced in February 2007 that it had acquired 33% of Swiss rival Converium Holding AG, and planned to acquire the Swiss company.\(^8\) Scor said it had purchased 8% through direct market purchases and the balance through share purchase agreements. Patinex, the investment vehicle for Swiss financier Martin Ebner, acknowledged it had accumulated and then sold to Scor close to 20% of Converium, in stock and options. The Swiss Federal Banking Commission later ruled that Ebner and Scor had acted together in acquiring Converium shares, but this ruling had little effect, since Converium later agreed to Scor’s takeover.

**B. The Swiss Regulatory Response**

Prior to 2007, Swiss disclosure rules were similar to current U.S. rules and required disclosure if an investor held more than 5% voting ownership in a Swiss public company. Physically settled call options counted toward the threshold, but cash-settled options and other derivatives did not. As we have seen, this led to widespread use of hidden ownership, which then morphed into access to shares and voting rights when needed.\(^8\)


In response to the events discussed above, the Swiss Federal Banking Commission amended its rules, effective July 1, 2007, to also require disclosure of cash-settled call options. Meanwhile, the Swiss Parliament rapidly adopted legislation, effective December 1, 2007, to reduce the disclosure threshold to 3% and to require disclosure of holdings of any financial product that would enable the holder to acquire voting rights with respect to a potential public takeover. In November 2007, the Commission, among other things, indicated that it would require additional disclosure of securities lending. This new regulatory regime should quell stealth takeovers, but leaves empty voting not directly addressed.

C. The Worldwide Scope of Decoupling

The Swiss examples of stealth takeover bids are dramatic. But what about the rest of the world? How much decoupling activity is there? Without effective disclosure, we don’t know. We can, however, collect examples—the visible tip of the potential iceberg. Table 1 provides such a list. It expands on a similar table in Decoupling I. We then had 21 examples; we’re now over 80.

This number seemingly grows almost anytime one of us travels somewhere, gives a talk, and asks the audience for examples we are not aware of. Moreover, as we discuss in Part III.B, the U.K. Takeover Panel has determined that after it changed its disclosure rules to cover cash-settled derivatives, the number of pertinent ownership disclosures increased by about 19% over the period November 7, 2005, to May 31, 2007. Our own preliminary search for these disclosures for May 2007 produced 13 instances of disclosed decoupling for that single month.

The supply and demand factors that promote decoupling remain in place. The emergence of huge sovereign wealth funds, and their increasing proclivity to take large stakes in Western public corporations, may add to this trend. Today, sovereign wealth funds hold $1.5-
2.5 trillion in assets—comparable to hedge funds. This level is growing rapidly, fueled by high oil prices. Borse Dubai used decoupling as part of its 2007 takeover bid for OMX Group, the Swedish stock exchange operator, apparently in violation of both Swedish and British rules.


Insider hedging was part of the reason for Hong Kong’s 2003 disclosure reforms, as discussed in Decoupling I. Similar hedging is rumored to take place elsewhere. The value of diversification is substantial enough so that, with hedging opportunities now widely available, it would be surprising if partial insider hedging were not widespread.

Table 1: Worldwide Significance: Cumulative Table of Decoupling Examples

This table lists, roughly in reverse chronological order, the known (or rumored) instances of decoupling of economic and voting ownership we were able to collect from a combination of public news stories, regulatory studies, and anecdotes provided by readers and workshop participants. An “X” in the “hidden ownership” column, without more, indicates that ownership was hidden; “X (disclosed)” indicates economic-only ownership that was not hidden. The table generally excludes cases of disclosed decoupling under the new U.K. Takeover Panel rules. The table is an expanded version of a similar table in Decoupling I and reflects the examples known to us as of year-end 2007. It is © 2008 Henry T. C. Hu.

<table>
<thead>
<tr>
<th>No.</th>
<th>Date</th>
<th>Host Company</th>
<th>Country</th>
<th>Vote Buyer or Hidden Owner</th>
<th>Empty Voting</th>
<th>Hidden Ownership</th>
<th>Other Goals</th>
<th>Coupled or Related Asset</th>
<th>Description</th>
<th>Documentation</th>
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<tbody>
<tr>
<td>82</td>
<td>on-going</td>
<td>many companies</td>
<td>U.S.</td>
<td>company itself</td>
<td>X</td>
<td></td>
<td></td>
<td>ESOP</td>
<td>Empty voting of non-vested shares.</td>
<td>See Part I.C.2.</td>
</tr>
<tr>
<td>81</td>
<td>on-going</td>
<td>many companies</td>
<td>U.S.</td>
<td>company itself</td>
<td>X</td>
<td></td>
<td></td>
<td>restricted stock</td>
<td>Empty voting from being able to vote restricted shares.</td>
<td>See Part I.C.2.</td>
</tr>
<tr>
<td>80</td>
<td>on-going</td>
<td>many companies</td>
<td>various</td>
<td>insiders</td>
<td>X</td>
<td></td>
<td></td>
<td>various</td>
<td>Insiders reduce economic stake by hedging, retain voting control</td>
<td>See footnote.</td>
</tr>
<tr>
<td>79</td>
<td>on-going</td>
<td>some companies</td>
<td>U.S., U.K.</td>
<td>insiders or company itself</td>
<td>X</td>
<td></td>
<td></td>
<td>various</td>
<td>Insiders expect close vote, arrange for friendly investors to engage in record date capture.</td>
<td>See Part I.C.2.</td>
</tr>
<tr>
<td>No.</td>
<td>Date</td>
<td>Host Company</td>
<td>Country</td>
<td>Vote Buyer or Hidden Owner</td>
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<tr>
<td>78</td>
<td>2007</td>
<td>Turkcell</td>
<td>Turkey</td>
<td>Alfa Group</td>
<td>X</td>
<td></td>
<td></td>
<td>re-purchase agreement</td>
<td>Arbitration panel orders Alfa to reduce stake in Kyivstar to under 5%; Alfa sells part of Turkcell (which owns part of Kyivstar) to Kazakh company, retains repurchase rights.</td>
<td>See Part V.A.</td>
</tr>
<tr>
<td>77</td>
<td>2007</td>
<td>Endesa</td>
<td>Spain</td>
<td>Enel</td>
<td></td>
<td></td>
<td></td>
<td>equity swaps</td>
<td>Enel uses swaps to acquire 25% of Endesa; direct holding of 9.99% is under 10% regulatory limit.</td>
<td>See footnote.</td>
</tr>
<tr>
<td>76</td>
<td>2007</td>
<td>Fortis</td>
<td>Netherlands</td>
<td>hedge funds (and rumors as to ABN Amro)</td>
<td></td>
<td></td>
<td></td>
<td>share loans</td>
<td>Record date capture, to influence Fortis's ability to raise funds to bid for ABN Amro.</td>
<td>See Part I.C.A.</td>
</tr>
<tr>
<td>75</td>
<td>2007</td>
<td>ABN Amro</td>
<td>Netherlands</td>
<td>Royal Bank of Scotland</td>
<td>X</td>
<td></td>
<td></td>
<td>equity swaps, call options</td>
<td>Takeover bidder quietly increases stake from 4% to 8%, then discloses new stake.</td>
<td>See footnote.</td>
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<td>No.</td>
<td>Date</td>
<td>Host Company</td>
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<td>74</td>
<td>2007</td>
<td>OMX</td>
<td>Sweden</td>
<td>Borse Dubai</td>
<td>X</td>
<td></td>
<td></td>
<td>call options</td>
<td>Borse Dubai emerges with 28.4% of OMX, mostly through option agreements with hedge funds, competes with NASDAQ deal to buy OMX.</td>
<td>See Part III.A.2.</td>
</tr>
<tr>
<td>73</td>
<td>2007</td>
<td>MOL</td>
<td>Hungary</td>
<td>MOL</td>
<td>X</td>
<td></td>
<td></td>
<td>share loans</td>
<td>As defense to take-over bid, MOL buys 40% of own shares, lends them to Hungarian banks, which can vote them.</td>
<td>See Part I.C.2.</td>
</tr>
<tr>
<td>72</td>
<td>2007</td>
<td>Target</td>
<td>U.S.</td>
<td>Pershing Square (hedge fund)</td>
<td>X (disclosed)</td>
<td></td>
<td>Avoid short-selling profit recapture</td>
<td>call options, equity swaps</td>
<td>Pershing Square initially acquires 9.6% of Target, mostly through equity derivatives; later announces holding 9.97% in shares and 12.6% total economic stake.</td>
<td>See footnote.</td>
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<th>No.</th>
<th>Date</th>
<th>Host Company</th>
<th>Country</th>
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<th>Other Goals</th>
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<tbody>
<tr>
<td>71</td>
<td>2007</td>
<td>TD Ameritrade</td>
<td>U.S.</td>
<td>Jana Partners, SAC Capital (hedge funds)</td>
<td>X</td>
<td>unspecified</td>
<td></td>
<td>Hedge funds seek sale of company, advise it that they have 8.4% stake, no 13D filing.</td>
<td>See Part II.A.</td>
<td></td>
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<tr>
<td>70</td>
<td>2007</td>
<td>Implenia</td>
<td>Switzerland</td>
<td>Laxey Partners (hedge fund)</td>
<td>X</td>
<td>cash-settled call options</td>
<td></td>
<td>Laxey announces 23% stake in Implenia; no prior disclosure.</td>
<td>See Part II.A.</td>
<td></td>
</tr>
<tr>
<td>69</td>
<td>2007</td>
<td>Converium</td>
<td>Switzerland</td>
<td>Scor (France)</td>
<td>X</td>
<td>cash-settled call options</td>
<td></td>
<td>Scor acquires 33% stake in Converium as part of takeover bid, without prior disclosure.</td>
<td>See Part II.A.</td>
<td></td>
</tr>
<tr>
<td>68</td>
<td>2007</td>
<td>CVS Caremark</td>
<td>U.S.</td>
<td>broker votes in director election</td>
<td>X</td>
<td>record ownership</td>
<td></td>
<td>Broker votes of client shares reelect director Roger Headrick despite &quot;vote no&quot; campaign.</td>
<td>See footnote.52</td>
<td></td>
</tr>
<tr>
<td>67</td>
<td>2007</td>
<td>Borders Group</td>
<td>U.S.</td>
<td>Spencer Capital Management</td>
<td>X</td>
<td>options</td>
<td></td>
<td>Spencer obtains 6.8% stake in Borders, about one-third of which is in form of options.</td>
<td>See footnote.55</td>
<td></td>
</tr>
<tr>
<td>No.</td>
<td>Date</td>
<td>Host Company</td>
<td>Country</td>
<td>Emptiness</td>
<td>Hidden Ownership</td>
<td>Hidden Voting</td>
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<tr>
<td>66</td>
<td>2007</td>
<td>Freports-McMoRan and others</td>
<td>U.S.</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>Antius Capital discloses that it owns 6.4% of Freepo, but had long economic exposure to 11.5% because of equity swaps and other derivatives.</td>
<td>See Part I.A.</td>
<td></td>
</tr>
<tr>
<td>65</td>
<td>2007</td>
<td>Victory Industrial &amp; Viktor Vekselberg</td>
<td>Switzerland</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>ZKB and Deutsche bank provide derivatives, but disclosure is not clear.</td>
<td>See Part I.A.</td>
<td></td>
</tr>
<tr>
<td>62</td>
<td>2007</td>
<td>Tribune</td>
<td>U.S.</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>Chandler family</td>
<td>See footnote.94</td>
<td></td>
</tr>
<tr>
<td>63</td>
<td>2007</td>
<td>Hayman, Kinetica, and Paulson money managers</td>
<td>U.K.</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>Money managers hold 23% of LSE, swap against LSE, and sell LSE stocks.</td>
<td>See footnote.95</td>
<td></td>
</tr>
</tbody>
</table>

94 Information on the Chandlers' plans to hedge is from a source familiar with the transaction. See also Michael Oneal & John McCormick, Tribune Co. Welcomes Zell to Board; Chandlers Exit, CHI. TRIB., May 10, 2007, § 3, at 1.

95 See James Quinn, No Resting on Their Laurels at the LSE, DAILY TELEGRAPH, Feb. 15, 2007, at 5. Information that the 23% position was held through derivatives was provided by a knowledgeable U.K. market participant.
<table>
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<tr>
<th>No.</th>
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<td>62</td>
<td>2007</td>
<td>Ascom</td>
<td>Switzerland</td>
<td>Victory Industrial (Austria)</td>
<td>X</td>
<td></td>
<td></td>
<td>cash-settled call options</td>
<td>Victory announces holding of 20% of Ascom, through shares and options.</td>
<td>See Part H.A.</td>
</tr>
<tr>
<td>61</td>
<td>2007</td>
<td>PT Multimedia</td>
<td>Portugal</td>
<td>Portugal Telecom (parent)</td>
<td>X</td>
<td></td>
<td></td>
<td>equity swaps</td>
<td>Portugal Telecom holds 58% of PT Multimedia directly, another 10% through equity swaps with Barclays.</td>
<td>See Part I.C.2.</td>
</tr>
<tr>
<td>59</td>
<td>2007</td>
<td>Stork NV</td>
<td>Netherlands</td>
<td>Centaurus and Paulson hedge funds</td>
<td>X</td>
<td></td>
<td></td>
<td>unspecified derivatives</td>
<td>Hedge funds holding 31% of Stork seek breakup; Stork claims they initially hid their ownership.</td>
<td>See footnote.</td>
</tr>
<tr>
<td>No.</td>
<td>Date</td>
<td>Host Company</td>
<td>Country</td>
<td>Vote Buyer or Hidden Owner</td>
<td>Empty Voting</td>
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<td>Coupled or Related Asset</td>
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<tr>
<td>58</td>
<td>2007</td>
<td>U.S. Global Investors</td>
<td>U.S.</td>
<td>unspecified hedge funds</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>Company claims that share volatility &quot;may be amplified&quot; by hedge funds engaging in empty voting who oppose charter amendments.</td>
<td>See Decoupling I.</td>
</tr>
<tr>
<td>57</td>
<td>2007</td>
<td>Ceridian Corp.</td>
<td>U.S.</td>
<td>Pershing Square (hedge fund)</td>
<td>X</td>
<td></td>
<td></td>
<td>OTC call options</td>
<td>Pershing makes initial disclosure because of share stake and later also acquires OTC call options.</td>
<td>See footnote.97</td>
</tr>
<tr>
<td>56</td>
<td>2006</td>
<td>Multi-Fineline-Electronix</td>
<td>U.S./Singapore</td>
<td>Stark (hedge fund)</td>
<td>X</td>
<td></td>
<td>unspecified hedges</td>
<td></td>
<td>Freezeout by parent company; Stark holds large position in parent plus hedged position in sub, supports freezeout.</td>
<td>See Decoupling I.</td>
</tr>
<tr>
<td>55</td>
<td>2006</td>
<td>EADS</td>
<td>Lagardere</td>
<td></td>
<td>X</td>
<td></td>
<td>convertible bonds</td>
<td></td>
<td>Lagardere issues bonds convertible into EADS shares, retains shares and hence votes until bonds are converted.</td>
<td>See footnote.98</td>
</tr>
<tr>
<td>No.</td>
<td>Date</td>
<td>Host Company</td>
<td>Country</td>
<td>Vote Buyer or Hidden Owner</td>
<td>Empty Voting</td>
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<tr>
<td>54</td>
<td>2006</td>
<td>Lindner Holding KGaA</td>
<td>Germany</td>
<td>Lindner Holding GmbH (controlling shareholder)</td>
<td>X</td>
<td></td>
<td>complete freeze-out</td>
<td>share borrowing</td>
<td>Parent uses borrowed shares to meet 95% threshold for freezeout; effort blocked by Munich appeals court.</td>
<td>See Part I.C.4.</td>
</tr>
<tr>
<td>53</td>
<td>2006</td>
<td>Hyundai Merchant Marine</td>
<td>Korea</td>
<td>Hyundai Elevator</td>
<td>X</td>
<td></td>
<td>avoid holding company rules</td>
<td>re-purchase agreement</td>
<td>Elevator seeks votes to block takeover bid by Hyundai Heavy Industries; will be regulated as holding company if holds shares directly; arranges for IXIS Bank to buy shares and vote as directed.</td>
<td>See Part V.A.</td>
</tr>
<tr>
<td>52</td>
<td>2006</td>
<td>Portugal Telecom</td>
<td>Portugal</td>
<td>Company itself</td>
<td>X</td>
<td></td>
<td></td>
<td>unspecified hedges</td>
<td>Sonaecom bids for Portugal Telecom, which places Treasury shares with Barclays; Barclays will vote against bidder, is protected against loss.</td>
<td>See Part I.C.2.</td>
</tr>
<tr>
<td>No.</td>
<td>Date</td>
<td>Host Company</td>
<td>Country</td>
<td>Vote Buyer or Hidden Owner</td>
<td>Empty Voting</td>
<td>Hidden Ownership</td>
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<tr>
<td>51</td>
<td>2006</td>
<td>Arcelor</td>
<td>Luxembourg</td>
<td>unspecified hedge funds</td>
<td>X</td>
<td></td>
<td></td>
<td>unspecified hedges</td>
<td>Hedge funds, supporting Mittal's bid, rumored to have acquired votes to</td>
<td>See footnote.</td>
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<td>oppose white square deal with Severstal.</td>
<td></td>
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<td>50</td>
<td>2006</td>
<td>Arcelor</td>
<td>Luxembourg</td>
<td>Company itself</td>
<td>X</td>
<td></td>
<td></td>
<td>Dutch foundation</td>
<td>Arcelor places shares of major subsidiary with Dutch foundation as defense</td>
<td>See footnote.</td>
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<td></td>
<td></td>
<td></td>
<td>against Mittal takeover bid.</td>
<td></td>
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<td>49</td>
<td>2006</td>
<td>Telent PLC</td>
<td>U.K.</td>
<td>Polygon (hedge fund)</td>
<td>X</td>
<td></td>
<td></td>
<td>share borrowing and/or</td>
<td>Polygon blocks acquisition of Telent, exercising voting power beyond its</td>
<td>See Decoupling</td>
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<td>equity swaps</td>
<td>economic interest.</td>
<td>l.</td>
</tr>
<tr>
<td>48</td>
<td>2006</td>
<td>Sears Canada</td>
<td>Canada</td>
<td>Pershing Square (hedge fund)</td>
<td>X</td>
<td></td>
<td>X</td>
<td>equity swaps</td>
<td>Sears Holdings wants to freeze out minority in Sears Canada subsidiary;</td>
<td>See Decoupling</td>
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<td></td>
<td>Pershing Square holds equity swaps in Sears Canada; Scotiabank is dealer</td>
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<td></td>
<td>manager for parent’s offer, refuses to unwind swap, plans to vote for</td>
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<td>offer.</td>
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<td>Host Country</td>
<td>Vote Buyer or Hidden Owner</td>
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<tr>
<td>47</td>
<td>2006</td>
<td>Saurer</td>
<td>Switzerland</td>
<td>Victory Industrial</td>
<td>X</td>
<td></td>
<td></td>
<td>cash-settled call options</td>
<td>Victory announces that it holds 45% stake—24% shares bought from Laxey Partners (see below) plus 21% through options—no prior disclosure, makes tender offer for rest of Saurer.</td>
<td>See Part II.A.</td>
</tr>
<tr>
<td>46</td>
<td>2006</td>
<td>Saurer</td>
<td>Switzerland</td>
<td>Laxey Partners</td>
<td>X</td>
<td></td>
<td></td>
<td>unspecified</td>
<td>Laxey announces in July 2006 that it holds over 25% stake in Saurer, no prior disclosure.</td>
<td>See Part II.A.</td>
</tr>
<tr>
<td>45</td>
<td>2006</td>
<td>Euronext</td>
<td>France</td>
<td>Company itself</td>
<td>X</td>
<td></td>
<td></td>
<td>unclear</td>
<td>French government recruits French banks to hold &quot;pool shares&quot; of Euronext to defend against Deutsche Börse takeover bid.</td>
<td>See Part I.C.2.</td>
</tr>
<tr>
<td>No.</td>
<td>Date</td>
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<tr>
<td>44</td>
<td>2006</td>
<td>Henderson Investment</td>
<td>Hong Kong</td>
<td>Hedge fund(s)</td>
<td>X</td>
<td>X (short position)</td>
<td></td>
<td>share borrowing + short sale</td>
<td>Parent Henderson Land proposed freezeout of its subsidiary, Henderson Investment. Hedge fund borrows enough shares to let it kill the freezeout, voted no, then sells short and profits when voting outcome is announced.</td>
<td>See Decoupling I.</td>
</tr>
<tr>
<td>43</td>
<td>2006</td>
<td>Time Warner</td>
<td>U.S.</td>
<td>Istithmar (private investment fund)</td>
<td>X</td>
<td></td>
<td></td>
<td>equity-linked notes</td>
<td>Istithmar acquires 2.4% economic ownership through equity-linked notes purchased from UBS, which agrees to &quot;consult&quot; its client before voting or disposing of its matched shares.</td>
<td>See footnote 101</td>
</tr>
<tr>
<td>42</td>
<td>2006</td>
<td>Phelps Dodge</td>
<td>U.S.</td>
<td>Atticus Capital (hedge fund)</td>
<td>X</td>
<td></td>
<td></td>
<td>options</td>
<td>Atticus becomes largest shareholder in Phelps Dodge.</td>
<td>See Part I.A.</td>
</tr>
</tbody>
</table>
Information on this transaction is from a private source. Personal knowledge of Bernard Black, arising from participation as expert witness in arbitration between IPOC International Growth Fund Limited (Bermuda) and OAO CT-Mobile case before the Arbitration Institute of the Stockholm Chamber of Commerce (2005-2006) for Barnett, D. Wolf, Big Investor Wants Changes at Wendy's, COLUMBUS DISPATCH, Apr. 27, 2005, at IA; Whitehouse, Enrich & Stein (2007), supra note 13.

<table>
<thead>
<tr>
<th>No.</th>
<th>Date</th>
<th>Host Company</th>
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<th>Documentation</th>
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<tr>
<td>41</td>
<td>~2005</td>
<td>Confidential company</td>
<td>U.S.</td>
<td>Hedge fund(s)</td>
<td>X</td>
<td>possible</td>
<td>???</td>
<td>Hedge fund holds 4.9% of shares, wants divestiture, rebuffed; 2 weeks later has 51% of votes, no apparent share accumulation (no market impact).</td>
<td>See footnote 102</td>
<td></td>
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<tr>
<td>40</td>
<td>2005</td>
<td>Unaxis</td>
<td>Switzerland</td>
<td>Victory Industrial (Austria)</td>
<td>X</td>
<td>physically and cash settled call options</td>
<td>Victory uses shares and options to accumulate 30% stake without prior disclosure.</td>
<td>See Part II.A.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>39</td>
<td>2005</td>
<td>OAO Megafon</td>
<td>Russia</td>
<td>Leonid Reiman</td>
<td>X</td>
<td>offshore trust</td>
<td>Reiman (Russian telecom minister) holds Megafon shares through trust; his lawyer controls trust, claims to be beneficial owner.</td>
<td>See footnote 103</td>
<td></td>
<td></td>
</tr>
<tr>
<td>38</td>
<td>2005</td>
<td>Wendy's Int'l</td>
<td>U.S.</td>
<td>Pershing Square (hedge fund)</td>
<td>X (disclosed)</td>
<td>options</td>
<td>Pershing reports holding 9.3% stake, with more than 6% in form of options.</td>
<td>See footnote 104</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No.</td>
<td>Date</td>
<td>Host Company</td>
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<tr>
<td>37</td>
<td>2005</td>
<td>Wendy's Int'l</td>
<td>U.S.</td>
<td>Trian and allied hedge funds</td>
<td>X</td>
<td>(disclosed)</td>
<td>matched call and put options</td>
<td>Trian mounts proxy campaign for spinoff of Wendy's subsidiary; its economic ownership is primarily through options.</td>
<td>See footnote.</td>
<td></td>
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<tr>
<td>36</td>
<td>2005</td>
<td>Banca Antonveneta</td>
<td>Italy</td>
<td>Banco Populare di Lodi</td>
<td>X</td>
<td></td>
<td>avoid mandatory bid rules</td>
<td>Banco Populare holds 29.3% of Antonveneta directly, 46% total; Consob requires mandatory bid.</td>
<td>See footnote.</td>
<td></td>
</tr>
<tr>
<td>35</td>
<td>2005</td>
<td>Fiat</td>
<td>Italy</td>
<td>Agnelli family</td>
<td>X</td>
<td></td>
<td>avoid mandatory bid rules</td>
<td>Agnelli family acquires equity swaps in Fiat, instead of shares, to preserve control without triggering mandatory bid rule, perhaps also to avoid disclosure and hence market impact.</td>
<td>See Decoupling II.</td>
<td></td>
</tr>
<tr>
<td>No.</td>
<td>Date</td>
<td>Host Company</td>
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<tr>
<td>34</td>
<td>2005</td>
<td>Austral Coal</td>
<td>Australia</td>
<td>Glencore</td>
<td>X</td>
<td>equity swaps</td>
<td>10% stake in Austral Coal through combination of disclosed share purchases and undisclosed swaps.</td>
<td>See Decoupling 1 and footnote.</td>
<td></td>
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</tr>
<tr>
<td>33</td>
<td>2005</td>
<td>Exar</td>
<td>U.S.</td>
<td>GWA Investments (hedge fund)</td>
<td>X</td>
<td>short sales</td>
<td>GWA seeks minority board seats; its position in Exar is 96% hedged.</td>
<td>See footnote.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>32</td>
<td>2005</td>
<td>Fuji TV</td>
<td>Japan</td>
<td>Nippon Broadcasting</td>
<td>X</td>
<td>stock lending</td>
<td>Deny voting rights to take-over bidder; Nippon lends its shares in Fuji TV to others as a defense to takeover bid by Livedoor; Nippon's economic ownership is morphable but not hidden.</td>
<td>See Decoupling 1.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31</td>
<td>2005</td>
<td>Deutsche Börse</td>
<td>Germany</td>
<td>Hedge funds</td>
<td>X</td>
<td>short sale of target shares</td>
<td>Opponents of Deutsche Börse bid for LSE, go long Deutsche Börse, short LSE.</td>
<td>See Decoupling 1.</td>
<td></td>
<td></td>
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<tr>
<td>No.</td>
<td>Date</td>
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<tr>
<td>30</td>
<td>2005</td>
<td>Portman Mining</td>
<td>Australia</td>
<td>Seneca (hedge fund)</td>
<td>X</td>
<td></td>
<td></td>
<td>equity swaps</td>
<td>Cleveland Cliffs bids to acquire Portman. Seneca holds 9% economic interest in Portman through equity swaps.</td>
<td>Decoupling II</td>
</tr>
<tr>
<td>29</td>
<td>2004-2005</td>
<td>WMC Resources</td>
<td>Australia</td>
<td>BHP Billiton</td>
<td>X</td>
<td></td>
<td></td>
<td>equity swaps</td>
<td>Acquisition of 4.3% toehold through equity swaps.</td>
<td>Decoupling II</td>
</tr>
<tr>
<td>28</td>
<td>2004-2005</td>
<td>Mylan Laboratories</td>
<td>U.S.</td>
<td>Perry Corp. (hedge fund)</td>
<td>X</td>
<td></td>
<td>equity swap</td>
<td></td>
<td>Perry and Citadel hold shares in King, which Mylan proposes to acquire; they buy hedged positions in Mylan to vote for the merger.</td>
<td>Decoupling II</td>
</tr>
<tr>
<td>27</td>
<td></td>
<td></td>
<td></td>
<td>Citadel (hedge fund)</td>
<td>X</td>
<td></td>
<td>unknown</td>
<td></td>
<td></td>
<td>Decoupling II</td>
</tr>
<tr>
<td>26</td>
<td>2004</td>
<td>DFS</td>
<td>U.K.</td>
<td>Polygon (hedge fund)</td>
<td>X</td>
<td></td>
<td>equity swap</td>
<td></td>
<td>Polygon seeks to influence DFS despite owning only one share of stock (it had 3% economic ownership through equity swaps).</td>
<td>Decoupling II</td>
</tr>
<tr>
<td>No.</td>
<td>Date</td>
<td>Host Company</td>
<td>Country</td>
<td>Vote Buyer or Hidden Owner</td>
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<tr>
<td>25</td>
<td>2004</td>
<td>Alvis</td>
<td>U.K.</td>
<td>Hedge</td>
<td>X</td>
<td></td>
<td></td>
<td>equity swap</td>
<td>Hedge funds with equity swaps as to Alvis shares support BAE Systems bid for Alvis.</td>
<td>See Decoupling I.</td>
</tr>
<tr>
<td>24</td>
<td>2004</td>
<td>Hyundai Merchant Marine</td>
<td>Korea</td>
<td>Hyundai Elevator</td>
<td>X</td>
<td>X</td>
<td></td>
<td>complex option and voting contract</td>
<td>Elevator wants to control more shares of Marine to block a takeover bid, arranges for Cape Fortune to hold them and vote as directed.</td>
<td>See Part V.A.</td>
</tr>
<tr>
<td>23</td>
<td>2004</td>
<td>Marks and Spencer</td>
<td>U.K.</td>
<td>Hedge</td>
<td>X</td>
<td></td>
<td></td>
<td>equity swap</td>
<td>Dealers who hold matched shares to hedge equity swaps support Green’s bid.</td>
<td>See Decoupling I.</td>
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<tr>
<td>22</td>
<td>2004</td>
<td>Canary Wharf</td>
<td>U.K.</td>
<td>“Songbird” consortium</td>
<td>X</td>
<td></td>
<td></td>
<td>equity swap</td>
<td>Derivatives dealer UBS holds 7.7% of Canary as matched shares to support equity swaps held by Songbird members.</td>
<td>See Decoupling I.</td>
</tr>
<tr>
<td>No.</td>
<td>Date</td>
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<tr>
<td>21</td>
<td>2004</td>
<td>MONY Group</td>
<td>U.S.</td>
<td>Holders and short sellers of AXA convertible bonds</td>
<td>X</td>
<td></td>
<td></td>
<td>Holders (short sellers) of AXA bonds support (oppose) merger with MONY, hoping to profit from AXA bond holdings.</td>
<td>See Decoupling II</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>2004</td>
<td>Disney Co.</td>
<td>U.S.</td>
<td>Broker votes in director election</td>
<td>X</td>
<td></td>
<td></td>
<td>Broker votes of client shares reelect CEO Michael Eisner despite &quot;vote no&quot; campaign.</td>
<td>See footnote 100</td>
<td></td>
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<tr>
<td>19</td>
<td>2004</td>
<td>News Corp.</td>
<td>Australia &amp; U.S.</td>
<td>Liberty Media</td>
<td>X</td>
<td>Hidden: yes Morpheable: maybe</td>
<td>Forward contract and equity swap</td>
<td>Liberty Media holds voting and nonvoting News Corp. shares, uses derivatives to adjust its economic exposure.</td>
<td>See Decoupling II</td>
<td></td>
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<tr>
<td>18</td>
<td>2003</td>
<td>SK Corp.; SK Telecom</td>
<td>Korea</td>
<td>SK Networks</td>
<td>X</td>
<td></td>
<td>Private contracts</td>
<td>SK Networks arranges for offshore money managers to hold SK Corp and SK Telecom shares, SK Networks retains economic risk and de facto voting rights.</td>
<td>See footnote 110</td>
<td></td>
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<tr>
<td>No.</td>
<td>Date</td>
<td>Host Company</td>
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<tr>
<td>16</td>
<td>2002</td>
<td>Moss Brothers</td>
<td>U.K.</td>
<td>Legendary Investments</td>
<td>X</td>
<td></td>
<td></td>
<td>equity swap</td>
<td>Legendary uses equity swaps to obtain 20% economic interest, obtains formal assignment of voting rights of matching shares from the counterparty.</td>
<td>See footnote 111</td>
</tr>
<tr>
<td>15</td>
<td>2002</td>
<td>Hewlett-Packard</td>
<td>U.S.</td>
<td>Holders of Compaq shares (target of HP merger bid)</td>
<td>X</td>
<td></td>
<td></td>
<td>target shares</td>
<td>Compaq shareholders are rumored to have acquired hedged HP positions to support HP's merger with Compaq.</td>
<td>See Decoupling 1.</td>
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<td>14</td>
<td>2002</td>
<td>Coles Myer</td>
<td>Australia</td>
<td>Solomon Lew (proxy contestant)</td>
<td>X</td>
<td>no</td>
<td></td>
<td>options</td>
<td>Lew buys additional shares, but hedges with options.</td>
<td>See Decoupling 1.</td>
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<td>Host Company</td>
<td>Country</td>
<td>Vote Buyer or Hidden Owner</td>
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<td>12</td>
<td>2002</td>
<td>British Land</td>
<td>U.K.</td>
<td>Laxey Partners</td>
<td>X</td>
<td></td>
<td></td>
<td>share borrowing</td>
<td>Laxey holds 1% of British Land, borrows another 8% to support a breakup proposal.</td>
<td>See Decoupling l.</td>
</tr>
<tr>
<td>11</td>
<td>2001</td>
<td>Telecom Italia</td>
<td>Italy</td>
<td>Unknown share borrowers</td>
<td>X</td>
<td></td>
<td></td>
<td>share borrowing</td>
<td>Fidelity and Morgan Stanley hold 10% of Telecom Italia, oppose Pirelli bid, but can cast only 1% of the votes; their other shares were lent and can’t be recalled in time.</td>
<td>See Part III.D.</td>
</tr>
<tr>
<td>10</td>
<td>2001</td>
<td>Fondiaria</td>
<td>Italy</td>
<td>SAI (acquirer)</td>
<td>X</td>
<td>avoid mandatory bid rule</td>
<td>call options</td>
<td>SAI parks Fondiaria shares with banks to avoid Italy’s mandatory bid rule, retains call options on the shares.</td>
<td>See footnote. 112</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>2001</td>
<td>Rubicon</td>
<td>New Zealand</td>
<td>Perry Corp.</td>
<td>X</td>
<td></td>
<td>equity swaps</td>
<td>Perry holds equity swaps to conceal ownership in Rubicon, later unwinds swaps and votes at Rubicon meeting.</td>
<td>See Decoupling I.</td>
<td></td>
</tr>
<tr>
<td>No.</td>
<td>Date</td>
<td>Host Company</td>
<td>Country</td>
<td>Vote Buyer or Hidden Owner</td>
<td>Empty Voting</td>
<td>Hidden Ownership</td>
<td>Other Goals</td>
<td>Coupled or Related Asset</td>
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<td>8</td>
<td>1999</td>
<td>Gucci</td>
<td>Netherlands</td>
<td>Company itself</td>
<td>X</td>
<td></td>
<td></td>
<td>ESOP</td>
<td>LVMH buys 34% stake in Gucci; Gucci establishes ESOP to hold equal number of shares, neutralizing LVMH's interest.</td>
<td>See Part I.C.3.</td>
</tr>
<tr>
<td>7</td>
<td>1997</td>
<td>John Fairfax Holdings</td>
<td>Australia</td>
<td>Brierley Investments</td>
<td>avoid mandatory bid rule</td>
<td>equity swaps</td>
<td></td>
<td>Brierley holds equity swaps instead of Fairfax shares to avoid Australia's mandatory bid rules.</td>
<td>See Decoupling 1.</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>1994</td>
<td>UBS</td>
<td>Switzerland</td>
<td>UBS</td>
<td>X</td>
<td></td>
<td></td>
<td>share borrowing, forward contracts</td>
<td>In response to take-over bid by Martin Ebner, UBS seeks to amend charter, agrees to repurchase shares from two major shareholders after a shareholder meeting; the shares are voted in favor of the amendment.</td>
<td>See Part I.C.2.</td>
</tr>
<tr>
<td>No.</td>
<td>Date</td>
<td>Host Company</td>
<td>Country</td>
<td>Vote Buyer or Hidden Owner</td>
<td>Empty Voting</td>
<td>Hidden Ownership</td>
<td>Other Goals</td>
<td>Coupled or Related Asset</td>
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<td>3</td>
<td>1989</td>
<td>Dunkin' Donuts</td>
<td>U.S.</td>
<td>Company itself</td>
<td>X</td>
<td></td>
<td></td>
<td>ESOP</td>
<td>Dunkin' Donuts adopts ESOP as defense against takeover bid Kingsbridge Capital and DD Acquisition.</td>
<td>See Part I.C.3.</td>
</tr>
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</table>
III. UPDATING OUR OWNERSHIP DISCLOSURE PROPOSAL

The developments described in Part II suggest that there is urgency to regulatory reform, in the United States and elsewhere. In Decoupling I, we argued that, in regulating equity decoupling, disclosure offers the best place to start.\textsuperscript{114} Section A summarizes the integrated ownership disclosure proposal we developed there, and reviews disclosure reforms in other countries. Section B evaluates the U.K.'s apparent success in implementing shareholder disclosure rules similar to those we propose. Section C extends our proposal to cover corporations. Section D proposes enhanced disclosure of share lending and borrowing.

A. Our Integrated Ownership Disclosure Proposal


The United States currently has five sets of ownership disclosure rules. With regard to equity decoupling, these rules treat economically similar positions differently both within and across disclosure regimes, allow much new vote buying to remain undisclosed, allow much economic-only ownership to remain hidden, provide little or no disclosure of share lending and borrowing, and do not directly address corporate decoupling. The current ownership disclosure regimes for shareholders are:

- active 5% shareholders report their voting ownership and material changes in ownership on Schedule 13D;
- passive investors report their voting ownership annually on Schedule 13G, plus a filing if they cross 10%;
- institutional investors holding over $100 million in U.S. equity securities report their share ownership (plus exchange traded call options) quarterly on Form 13F;
- insiders (directors, officers, and 10% shareholders) report their economic ownership under section 16 of the Exchange Act; and
- mutual funds report their economic ownership quarterly, through Forms N-1A, N-CSR, and N-Q.

The proxy rules and the tender offer rules may require additional disclosures by someone who launches a proxy contest or a tender offer.

To complicate matters further, the ownership positions that trigger the disclosure requirements and the positions that must be disclosed once disclosure is required are often different. For example, a 13D filer must disclose contracts related to the company's shares, presumably including equity swaps. But equity swap holdings do not count toward the disclosure threshold. Similarly, a 10% shareholder must disclose economic ownership under section 16, but economic-only ownership does not count toward the 10% threshold. OTC derivatives are often not subject to disclosure when an equivalent position using exchange-traded derivatives would be captured. Holding a call option is sometimes treated differently from the nearly equivalent writing of a put option.

These differences may once have made sense and some of the gaps may once have been unimportant. But in a world of easy, large-scale decoupling of economic from voting ownership and often easy recoupling when needed, a massive OTC derivatives market, and a pool of sophisticated hedge funds with the skill and incentives to use decoupling to hide ownership or cast empty votes, broader, more consistent coverage is needed.

We thus offered an "integrated ownership disclosure" proposal that would provide improved public disclosure of both empty voting and hidden ownership, while also streamlining the current ownership disclosure rules. Our proposal contemplated:

1. consistency as to which positions count toward disclosure thresholds, and which positions must be disclosed if the threshold is crossed;
2. disclosure of both voting and economic ownership, arising from shares or coupled assets;
3. symmetric disclosure of positive and negative economic ownership;
4. reporting of share lending and borrowing positions; and
5. reporting of significant instances of empty voting, above a threshold percentage of the company's shares, such as 0.5%.

The proposal would ensure that economic-only ownership, whether morphable or not, is not hidden. We would require real-time disclosure of most empty voting by 13D and 16(b) filers, who must report ownership changes promptly, but only delayed reporting by other filers.

We discuss the policy factors bearing on the optimal level of shareholder disclosure in Decoupling I, and do not repeat that analysis here. These requirements are rooted in the belief that investors, as
well as society at large, should know who a company's major shareholders are. Investors should also know whether those shareholders are buying and selling and should have an opportunity to respond. From an economic standpoint, share pricing will be more efficient if investors know what major investors are doing and have advance notice of possible changes in control. The integrity of, and confidence in, the stock market will be enhanced. We also identified reasons more directly related to equity decoupling. Disclosure can provide information on the frequency of empty voting and hidden (morphable) ownership. Disclosure may also deter some new vote buying: not everyone will do in the sunshine what they will do in the dark. Moreover, some empty voting strategies may be less effective if disclosed.

2. Regulatory Action to Date

Our integrated ownership disclosure proposal is consistent with regulatory changes made by the U.K. Takeover Panel in November 2005 to govern ownership disclosure during takeover bids, in Hong Kong in 2003 in response to aspects of the new vote buying, and in Switzerland this year in response to the events recounted above.115

Other regulators have also responded or are considering how to respond to equity decoupling. In the U.K., the Financial Services Authority has issued a consultation paper on disclosure reforms, which would apply generally, not just during takeover bids.116 In Hong Kong, the Securities and Futures Commission (SFC) reviewed the effectiveness of its 2003 reforms, released a consultation paper in 2005, and put together a working group of market participants and investors to investigate possible changes.117 The Italian securities regulator, Consob, is expected to review soon how its disclosure rules should respond to hidden ownership. In September 2007, the Australian Takeovers Panel issued a draft guidance note and a discussion paper, seeking public comment on an approach that contemplates treating equity derivatives, whether physically settled or cash-settled, the same as hold-

115 See id. at 879-80.
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ings of shares for both disclosure and mandatory bid rules. In the Netherlands, a May 2007 report by the Corporate Governance Code Monitoring Committee expresses concern with both disclosure of significant holdings and empty voting; the Finance Ministry has placed the Committee’s report at the top of its work program for 2008.

In the United States, both the SEC and the Delaware judiciary have shown concern over decoupling. Institutional investors have noted the importance of the issue. Senior SEC officials, including


121 For example, Delaware Supreme Court Justice Jack Jacobs has stated that, “[s]hould an egregious case of empty voting abuse arise, that in turn may lead to legislation and to court decisions that would result in a new paradigm for share voting.” Jack B. Jacobs, Paradigm Shifts in American Corporate Governance Law: A Quarter Century of Experience, CORP. GOVERNANCE ADVISOR, Sept.–Oct. 2007, at 1, 4.

122 See, e.g., Ben White, Concern in US over “Empty Voting,” FIN. TIMES (London), Oct. 6, 2006, at 29 (quoting John Wilcox of TIAA-CREF as saying that decoupling “undermine[s] the most fundamental assumption in corporate governance”); Ben White, Thesis on Hedge Fund Tactics Gives Investors a Shock—Professor’s Warning on “Empty Voting” Has Had Big Impact in the US, FIN. TIMES (London), Oct. 6, 2006, at 29 (noting the impact of
Chairman Christopher Cox and Commissioner Paul Atkins, have spoken publicly about empty voting and hidden (morphable) ownership. There have been published rumors as to forthcoming SEC disclosure reforms, but as yet no proposed rules.\textsuperscript{123}

\textbf{B. U.K. Experience with Disclosure Reform}

Recent U.K. experience provides reason to believe that disclosure reform, along the lines we propose, is workable and not unduly costly. We review that evidence in this section.

Since November 2005, the U.K. Takeover Panel has required disclosure of both long and short economic ownership of 1\% or more in a target company during the pendency of a takeover bid, though not at other times. This includes ownership through cash-settled "contracts for differences" or "CFDs" (the British version of equity swaps).\textsuperscript{124} The 1\% threshold aside, these reforms are similar to our proposal. In 2007, the Takeover Panel Executive invited comments on the new regime from trade bodies, hedge funds, companies which had received takeover offers, money managers, and other capital market participants. It received 89 responses out of 113 contacted entities. The Panel Executive also sought to determine how the disclosure reforms affected the number of filings.\textsuperscript{125} It estimated that filings increased by approximately 19\% over the period from November 2005 through May 2007. The overwhelming majority of the additional disclosures involved CFDs. The Executive found that these disclosures were generally not complex or difficult to understand.

There was strong support for the enhanced disclosures across all constituencies. Ninety percent of the respondents favored the new disclosure regime, and most of those agreed that the rules had significantly improved market transparency during offer periods. The Panel Executive felt that the responses indicated that market participants

\textsuperscript{123} See Ron Orol, SEC Eyes Investors in Takeover Fights, DAILY DEAL, May 14, 2007 (reporting rumors as to possible new SEC disclosure rules to address decoupling).


\textsuperscript{125} TAKEOVER PANEL CODE COMM. (U.K.), DERIVATIVES AND OPTIONS REGIME: 2007 REVIEW (June 29, 2007).
had little difficulty in analyzing the disclosures. The Panel Executive’s report concluded that the disclosure rules were achieving the Panel’s principal objectives without imposing undue burdens on market participants and, accordingly, that the rules were a proportionate regulatory response to the use of derivatives during takeover bids.

In November 2007, the Financial Services Authority (FSA), Britain’s umbrella financial industry regulator, proposed disclosure rules for CFDs. Unlike the Takeover Panel rules, this proposal is not limited to the period during a takeover bid. The FSA advanced two alternative approaches for public comment. The first would deem a holder of CFDs to have access to voting rights unless the holder meets safe harbor requirements, including an explicit agreement with the CFD writer that precludes the holder from exercising or seeking to exercise voting rights, plus the holder’s statement that it does not intend to use CFDs to seek access to voting rights. If the safe harbor were not met, CFDs would be disclosable if the holder’s combined CFD and share position exceeded 3%. If the safe harbor was met, the issuer could still require disclosure of economic interests above 5%. The second alternative would require disclosure of all CFDs and other equity derivative-based economic interests above a 5% threshold, which would be separate from the 3% disclosure threshold for shares, with no aggregation across the two types of holdings.

Some hedge funds themselves have advocated increased transparency. In an effort to guide or perhaps deflect regulation by the U.K. and other European countries, a group of 14 leading London-based hedge funds convened a working group (Hedge Fund Working Group) to prepare a hedge fund code of conduct, covering disclosure and other matters. The Working Group’s report, issued in October 2007, supports disclosure reform. The report recommends that European regulators adopt rules requiring all market participants to disclose economic-only interests, including those held through equity swaps. The Working Group agreed that companies “have a right to

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127 Id. ¶ 1.30, 5.35.
128 Id. ¶ 1.32, 5.51–5.53, 5.57.
know who owns them" as well as those "who [have] an ability to easily obtain significant voting power"—that is, those with morphable ownership. The Working Group recommended legal action because it believed that voluntary disclosure by some hedge funds would cause distortions because only some market participants would provide this disclosure. The Working Group members stated their willingness to work with regulators on the details of a mandatory regime, applicable to all parties, that "ties votes to underlying economic exposure."

C. Extending Our Disclosure Reform Proposal to Corporate Decoupling

In Decoupling I, we focused on decoupling by hedge funds and other outside investors. We were less concerned with insider disclosure, because current section 16(b) disclosure already captures economic ownership, and we did not discuss soft parking or other corporate decoupling. We now need to do so.

1. Current Disclosure Rules for Corporate Decoupling

We review in this section the rules that apply to soft parking and other corporate decoupling; we propose additional disclosures in the next section. Assume that a corporation engages in soft parking of shares, in one of the ways outlined above. To make the analysis concrete, assume that the company takes the long side of equity swaps with a derivatives dealer, expecting the dealer to hedge with matched shares and vote with management. What disclosure rules apply?

No specific "line item" rules clearly apply. In some circumstances, general disclosure principles based on "materiality" may apply. However, the SEC's past actions on disclosure of stock repurchases suggest, at best, ambiguity as to the need for disclosure in many circumstances. Stock exchange rules also provide no clear disclosure requirements.

The most directly relevant disclosure rule relates to corporate repurchases of shares. Until 2003, the SEC did not have a specific rule on disclosure of share repurchases. In late 2002, the SEC proposed adding Item 703 to Regulation S-K. In its proposing release, the SEC

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130 Hedge Fund Working Group (2007), supra note 129, at 47.
131 Id. at 61.
specifically asked for comments on whether corresponding disclosure should be required for derivatives transactions.\textsuperscript{133}

The SEC apparently decided not to require disclosure of derivatives transactions. Neither Item 703 nor the adopting release refers to derivatives transactions.\textsuperscript{134} Under Item 703 and associated changes to Forms 10-Q and 10-K, companies must provide information on purchases of "shares or other units of any class of the issuer's equity securities" registered under the Exchange Act.\textsuperscript{135} Equity swaps are generally not considered securities, nor are they registered under the Exchange Act, so they are not covered.\textsuperscript{136}

If a derivatives transaction is financially material, it might be captured as part of the quarterly umbrella Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) disclosure requirement.\textsuperscript{137}

In particular, MD&A disclosure includes various "off-balance sheet arrangements," defined to include "[a]ny obligation . . . under a contract that would be accounted for as a derivative instrument."\textsuperscript{138} This term would include equity derivatives. However, MD&A disclosure is required only for off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.\textsuperscript{139}

\textsuperscript{135} Regulation S-K, Item 703, 17 C.F.R. § 229.703(a) (2007).
\textsuperscript{136} "Security-based swap agreements" are not considered securities under Securities Act § 2A(b)(1), 15 U.S.C. § 77b-1(b) (2000), and Exchange Act § 3A(b)(1), 15 U.S.C. § 78c-1(b) (2000). Item 703 deals with a company's purchases of shares and related equity securities. Regulation S-K, Item 701, 17 C.F.R. § 229.701 (2007), addresses sales of unregistered securities. Item 701 might be implicated in some soft parking arrangements. However, we expect that the most likely forms will involve transactions in OTC equity derivatives. In part, this reflects the nature of the underlying soft parking transactions; in part, it reflects the reality that if a company can achieve the same soft parking end in two economically similar ways, it will often prefer the form that avoids disclosure.
\textsuperscript{137} See LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 175 (5th ed. 2004).
For the arrangements that concern us here, the primary impact is not on the company’s finances but on voting rights. Some of the transactions we discuss above, if large enough, might have a financially material impact—for example, a large long equity swap position. But others would not. A share loan, for example, has no financial statement impact. We know of no SEC statement suggesting that a potential effect on control alone would trigger MD&A disclosure.

Corporate soft parking might implicate other SEC disclosure rules or principles, or general antifraud provisions. But the analysis is even muddier. A company must file a Form 8-K on the occurrence of certain events, generally within four business days after occurrence. One such occurrence is when the company enters into a “material definitive agreement not made in the ordinary course of business” or any material amendment thereof.\(^{140}\) If so, Item 1.01 requires the company to provide information about the agreement. This requirement would likely capture a single equity swap contract, if it was large enough to be “material.” How large that is, we can’t be sure. Whether it captures a material effect on voting power, without a material effect on the company’s finances, is uncertain. Whether Item 1.01 captures the gradual accumulation of a position, through many smaller transactions, is also unclear. Nor do we know how much the company must say, if it reports anything.

Broad SEC disclosure principles and antifraud provisions are similarly unhelpful. Under both the Securities Act of 1933 (Securities Act) and the Exchange Act, companies are required to provide “such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.”\(^{141}\) These general principles provide little guidance as to when or how a soft parking transaction would need to be disclosed.\(^{142}\)

Stock exchange rules are no more helpful. The NYSE requires listed companies to notify it quarterly if the company acquires or dis-

\(^{140}\) SEC Form 8-K, Item 1.01(a) (2006).
\(^{142}\) The Rule 10b-5 ban on insider trading covers corporate repurchases of shares, and presumably applies as well to the equity swaps hypothetical. A corporation’s knowledge of the “true” distribution of votes may well be inside information. However, insider trading liability rests on the same materiality requirement that underlies the company’s public filings. Moreover, the usual insider trading rule is “disclose or abstain.” Here, the counterparty will often have the same information as the company. It thus seems unlikely that insider trading rules will have much impact on corporate soft parking.
poses of its shares. The timing is different than for SEC rules, but the rule appears to reach only shares, not derivatives. Companies must also notify the Exchange if the available public float is diminished "by the deposit of stock under a voting trust agreement, or other deposit agreements." This language could perhaps be stretched to cover share loans, but even if so stretched, disclosure is only to the Exchange, not to the public. The NYSE and NASDAQ require companies to timely disclose information that may affect security values or influence investment decisions, such as stock buyback programs. But whether this general disclosure principle reaches corporate decoupling is unclear.

Corporate soft parking is not, to our knowledge, currently disclosed. This might mean it doesn't happen. It could also mean that it occurs but is outside—or is deemed by companies to be outside—current disclosure rules.

2. Corporate Decoupling: Disclosure Proposal

For shareholders, we propose disclosure of both voting ownership and economic ownership, partly to reflect the practical reality that an economic-only owner often has de facto access to votes when needed. For 13D filers, this disclosure would be on a close to real-time basis (within ten days after crossing the 5% threshold), and would prompt reporting of changes thereafter. Schedule 13D also requires filers to attach pertinent agreements.

For corporations, we propose that they disclose significant transactions in their shares or equity derivatives, and any share borrowing or lending, following the 13D pattern. To ensure close to real-time disclosure, initial reporting would be on Form 8-K, with follow-up periodic reporting on Forms 10-Q and 10-K. Relevant agreements would be attached to these filings. Form 8-K is generally required to be filed within four business days after a triggering event, which is roughly comparable to Schedule 13D; we would not change this timing.

More specifically, one could revise Form 8-K, Item 1.01, to specify that the acquisition of voting or economic ownership, or the borrowing or lending of shares, beyond some threshold amount (perhaps

144 Id. § 204.09.
145 Id. § 201.00; NASDAQ Marketplace Rule IM-4120 (2007).
1% by the corporation should be disclosed, and relevant agreements attached as exhibits. As for shareholders, voting ownership would be determined in accordance with Schedule 13D precepts, while economic ownership would be determined in accordance with section 16 precepts. Economic ownership would be measured in the same crude manner we propose for shareholder disclosure, ignoring option deltas.

D. Reporting Shares Lent and Voted on Form 13F

In Part IV.C, we suggest that regulators should encourage, but not require, share lenders to recall and vote shares on record dates. In Decoupling I, we proposed that Form 13F filings by institutional investors should disclose their share lending and borrowing on record dates. We also proposed that 13F filers (and other periodic filers such as mutual funds) report any occasions where they cast substantially more votes than their economic ownership. To limit the reporting burden for filers who engage in ordinary hedging activities, we would require disclosure only if a filer cast a number of votes which exceeded its economic ownership by at least 0.5% (or some other threshold amount) of a company's outstanding shares.

We propose here somewhat expanded disclosure: if an institution owns shares in a company on a record date, it should disclose in its next Form 13F filing its total economic ownership (including coupled assets); the number of potentially votable shares (shares held directly or in street name), the number of shares lent, the number of shares borrowed, and the number voted. This would provide a fuller picture of the institution's voting (including empty voting), borrowing, and lending activity. We would not require investors to vote their shares, merely to disclose whether they had done so. To limit the disclosure burden, we would allow several exceptions:

1. An institution would not need to report economic ownership below a threshold dollar amount, or a threshold fraction of its total assets, if that ownership reflects long or short positions in broad market indices. For example, an institution which holds S&P 500 Index futures would not need to adjust its reported ownership of every company in the index.

147 An exception to the requirement to attach related agreements might be appropriate for derivatives transactions that follow a standard, publicly available form contract.
An institution would not need to report share borrowing or lending if the net amount fell below a threshold amount, measured as a fraction of its holdings, the company's outstanding shares, or both.

An institution would not need to report number of shares voted if its holdings of potentially votable shares fell below a threshold amount, measured as a fraction of its holdings or the company's outstanding shares.

We would require only omnibus disclosure of voting—were the shares voted or not? We would not impose the additional burden of reporting how many shares were voted on each agenda item.

This disclosure may give institutional investors incentives to vote the shares they economically own, and only the shares they economically own, to avoid the potential embarrassment of being a known empty voter. These disclosures would likely prompt some institutions to improve their practices with respect to exercising voting rights, including ensuring that they can recall and vote shares if they want to.

Currently, most institutions treat share lending and proxy voting as distinct activities. Sometimes, they discover too late that shares which they planned to vote have instead been lent by their share lending office or a lending agent. One such incident was prominent enough to merit inclusion in our decoupling list (see Table 1, supra). In 2001, Fidelity and Morgan Stanley, together holding 10% of Telecom Italia, led a campaign against a takeover offer by Pirelli. They discovered, however, that they held only 1% of the votes; their remaining shares had been lent and could not be recalled in time for the shareholder meeting, at which the Pirelli bid was approved. Who voted the shares is unknown.

We offer a specific reform proposal on share recall procedures infra in Part IV.C.2. There may be additional benefits to greater transparency with respect to stock lending and borrowing. For instance, in September 2007, criminal charges were brought against former stock loan employees at a number of brokerage firms; prosecutors allege that because prices in the share loan market were so obscure, the employees could rip off their own firms by arranging for the firms to overpay when borrowing shares. See Floyd Norris, Stock Loans Are No Place for Secrecy, N.Y. TIMES, Sept. 28, 2007, at Cl.

See Inst'l S'holder Servs., ISS Share Lending Flash Survey (2007) (PowerPoint presentation provided by Diana Bourke to Henry Hu) (discussing survey findings on institutional investors' voting and lending policies).

Kirchmaier & Grant (2005), supra note 112, at 18-22. There were rumors that the votes may have found their way to Pirelli.
It may be useful to compare our proposal to the SEC's rule requiring mutual funds to disclose how they voted on proposals presented at shareholder meetings. We would not require disclosure of how the 13F filer voted, only whether it voted or not. However, the mutual fund rule requires no disclosure of number of shares voted; we would require this disclosure. In short, the mutual fund rule requires disclosure of voting direction, but not magnitude. In theory a fund could own 3 million shares, vote one of them for a proposal, abstain for the rest, and report that it had supported the proposal. Our proposal requires the reverse: magnitude, but not direction. Mutual funds would be subject to both rules.

IV. RESPONSES TO EMPTY VOTING: BEYOND DISCLOSURE REFORM

A. Overview

Enhanced disclosure may be a sufficient response to hidden ownership, which would no longer be hidden. It will also open windows into the share lending market and into the extent of empty voting. Disclosure is likely to reduce the incidence of empty voting. Shareholders and firms will not always do publicly what they might do in secret. Soft parkees, derivatives dealers, and other facilitators would incur increased reputational risk. At ZKB, for example, the CEO and the head of derivatives trading lost their jobs and suffered front page ignominy, in significant part due to ZKB's role in the hidden attack on Sulzer.

But some firms, shareholders, and third-party facilitators will barrel ahead. In Hungary, MOL made no secret of lending 40% of its shares to friendly local banks to fend off OMV's takeover bid. In the United States, firms have publicly placed mostly empty votes with ESOP plans as a takeover defense. In Korea, Hyundai Elevator's initial hard parking of shares in Hyundai Merchant Marine remained in place, even though later disclosed; and Hyundai Elevator later openly


152 We discuss Sulzer, and ZKB's role, supra in Part II.A.

153 We discuss OMV's bid for MOL supra in Part I.C.2.
expanded the parking arrangement with a second counterparty. Disclosure will also likely do little to deter the use of decoupling to avoid mandatory bid rules.

Sometimes, too, disclosure will come too late to matter. Consider the Henderson Investments scenario described in Decoupling I. One or more hedge funds borrowed shares just before the record date for a merger vote, voted them against an apparently beneficial transaction, and then sold the shares short before the meeting date, profiting while defeating the transaction. After-the-fact disclosure would not have changed its ability to profit at other shareholders' expense.

Or consider the inability of Pershing Square, a major economic owner of Sears Canada through equity swaps, to obtain the matched shares in Sears Canada that were held by Bank of Nova Scotia (Scotiabank). In substance, Scotiabank was an empty voter, akin to a nominal holder, while Pershing Square was the economic owner. Or, perhaps Sears Holdings was the true empty voter. The Ontario Securities Commission blocked Scotiabank from voting, finding that Sears Holdings had offered side consideration to Scotiabank. It would otherwise have voted, despite Pershing Square's public complaints.

As we discussed in Decoupling I, there are circumstances in which decoupling can be beneficial, and in which a suitably regulated market for votes, decoupled from shares, could work reasonably well. It is also hard to regulate an activity that can take many shifting forms. We therefore offered a menu of regulatory approaches, but made no specific recommendations. The developments since, discussed in Part II, suggest that we should be less cautious. There is need, we now believe, for measured regulatory responses to address the risks posed by decoupling. Moreover, it is likely better to regulate sensibly and gently now, before a crisis hits, than to wait and risk a postcrisis overreaction. Below, we discuss three families of strategies.

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154 We discuss Hyundai Elevator's use of decoupling to avoid Korea's holding company rules infra in Part V.A.
155 We discuss the Henderson Land case in Hu & Black, Decoupling I (Law Review Version) (2006), supra note 1, at 834-35.
156 We discuss Pershing Square-Sears Canada in Hu and Black, Decoupling I (Finance Version) (2007), supra note 1, at 352.
158 Shaun P. Martin and Frank Partnoy have proposed eliminating all voting rights for anyone who hedges even part of their interest, but they did not propose specific implementation strategies. See Shaun Martin & Frank Partnoy, Encumbered Shares, 2005 U. ILL. L. REV. 775, 793-94. We discuss and criticize their proposal in Hu & Black, Decoupling I (Law Review Version) (2006), supra note 1 at 888-90. A subsequent work pro-
One family focuses on voting rights (Section B): when should the voting rights of an empty voter be limited based on economic ownership? We propose amending corporate law to provide constrained power for corporations to amend their charters to limit empty voting. We would constrain this power in a number of ways, including majority of minority approval of the charter amendment, to reduce the risk that insiders will propose amendments that block the empty voting techniques favored by outsiders, while permitting those favored by insiders. We develop a proposal for an “attestation” charter provision, which would require major shareholders to attest to their economic ownership, and would limit voting rights above the attested level. We would also amend corporate law to bar voting by shareholders with negative economic ownership. And we would extend current rules governing record holders to also apply to derivatives dealers who hold matched shares to hedge a short equity derivatives position held by an investor. We would generally require the dealers to pass voting rights through to their counterparty, who is the economic owner.

A second family of strategies focuses on supply and demand forces relating to the new vote buying (Section C). We recommend that regulators provide a safe harbor to allow institutional investors to recall and vote lent shares without risking a fiduciary duty lawsuit for not lending the shares instead. (Recall from Part III that our disclosure proposal would require 13F filers to disclose whether they voted or lent their shares.) Regulators should encourage, and perhaps require, large institutional lenders to develop the ability to recall lent shares on short notice. And record owners who have lent shares held in street name should be required to recall a number of shares sufficient, based on past experience, to honor the expected number of client voting instructions.

Third, the mechanics of shareholder voting need rethinking (Section D). Our proposal on limiting share loans by record owners should reduce the problem of “overvoting.”


Overvoting involves a record owner which, having lent some of its shares, seeks to cast more votes than its remaining votable shares. See Kahan & Rock (2007), supra note 158, at 31.
state law should be amended to allow companies to honor the properly cast votes (counting yes and no votes proportionately to the votes cast). Voting agendas should be available before the record date. And dividend and voting record dates should be separated.

Some larger changes in the voting architecture are also appropriate in an electronic age, and would improve the quality of voting. Economic owners should vote directly, instead of the current clumsy and often faulty system in which record owners solicit voting instructions and then try to follow them. And the time gap between the record date and the meeting date should be dramatically shortened.

We assume familiarity with the menu of possible approaches we presented in *Decoupling I*, and with the current voting system.\(^{160}\) We focus on specific proposals, which we believe should be adopted in the near term, and on amendments to U.S. rules. We address European reforms in related work.\(^{161}\)

### B. Voting Rights

#### 1. Direct Limits on Voting Rights

One way to address empty voting is to limit the voting rights of shareholders who hold greater voting than economic ownership. This solution may seem obvious in extreme cases, such as the negative economic ownership. But that extreme case aside, when it is appropriate to limit voting rights is as yet unclear. For complex positions, how to measure economic ownership can also be unclear. We therefore propose an incremental approach. Delaware (and other states) should amend its corporate law to permit firms to modify their charters to limit voting rights based on a shareholder's economic ownership.\(^{162}\) This will permit firms to experiment with different approaches. Be-

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161 Hu & Black, Debt, Equity, and Hybrid Decoupling (2008), supra note 4.

162 One could argue that this power is already conveyed by a general provision such as section 212(a) of the Delaware General Corporation Law, which provides, “Unless otherwise provided in the certificate of incorporation . . . , each stockholder shall be entitled to 1 vote for each share of capital stock held by such stockholder.” DEL. CODE ANN. tit. 8, § 212(a) (2001). However, one could also view this provision as conveying power to specify in the charter the voting rights conveyed by each share, not power to condition voting rights on attributes of the shareholder, such as whether the shareholder also holds coupled or related non-host assets.
low, we discuss the general proposal, and develop one possible im-
plementation, in which large shareholders would attest to their eco-
nomic ownership when they vote.

The key risk for a charter amendment is that insiders will propose
amendments that allow decoupling techniques likely to be used by in-
siders, while restricting techniques likely to be used by outsiders. This
risk is especially high for "midstream" charter amendments by already
public companies. We would therefore limit the scope of permis-
sible charter provisions in a number of ways. First, a midstream charter
amendment should be approved by a majority vote of nonaffiliated
shareholders in a separate vote, not tied to any other agenda item.
Second, any charter provision should be facially neutral—it should
not exempt particular classes of persons or particular levels of owner-
ship, should not permit case-by-case exemptions, and should not de-
pend on the period for which shares have been held. Time-phased
rules are a familiar way to privilege insiders, who are more likely to
meet the time restrictions. Third, the rules should not be puni-
tive—a shareholder should not lose a large number of votes because
of a small disparity between economic and voting ownership. Fourth,
the rules should permit holding shares in street name, as long as the
record holder votes based on instructions from an economic owner.
Fifth, there should be an expedited procedure for shareholders to ver-
ify, before voting, whether their votes will count. There should be no
ex post "gotchas," in which a firm's insiders deny votes to a particular
shareholder and thereby win a close vote they would otherwise have
lost. Sixth, judges should have equitable jurisdiction to uphold the
spirit of the charter provision and allow (deny) voting rights in situa-

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163 On the risks posed by midstream charter amendments, see Lucian Arye
Bebchuk, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Char-
ter Amendments, 102 HArv. L. Rev. 1820, 1823 (1989); Bernard S. Black, Is Corporate Law
of minority requirement prior to going public is not feasible, but also not important.
Most scholars believe that a pre-IPO charter provision is not likely to be seriously ineffi-
cient, because if it were, the insiders would expect to receive a lower price for their
shares. See, e.g., Robert Daines & Michael Klausner, Do IPO Charters Maximize Firm

164 This proposal draws, in spirit, from the general "self-enforcing" approach to
corporate law proposed in Bernard Black & Reinier Kraakman, A Self-Enforcing Model of

165 NYSE rules do not allow time-phased voting. NYSE Euronext, Listed Company
Shareholder attestation offers an approach that satisfies these criteria and avoids the problems with specifying particular types of permitted or not-permitted decoupling, or developing a detailed measure of economic ownership. A company could adopt a charter provision requiring major shareholders, say those holding over 1% of its shares, to attest when voting that the voted shares do not exceed their economic ownership by a specified percentage—say, by 20%. In computing economic ownership, we would let shareholders not count general hedges (long company X, but also short a broad index that includes company X). For simplicity, the attestation would involve only coupled assets, not related non-host assets. This relatively soft approach will reduce the number of instances in which votes are disallowed, as well as related transaction costs, while still ensuring that votes are generally cast by people with incentives to increase firm value. Since for some derivative positions, economic ownership can vary with share price, the attestation should be as of the record date.

This proposal assumes adoption of our separate proposal that economic owners should vote directly, rather than indirectly by giving instructions to record owners. If record owners vote, the attestation obligation would follow the voting rights they pass to economic owners.

This proposal would put the burden on the shareholder to monitor its own economic ownership, and cast only the number of votes to which it is entitled. The company could not by itself go behind the attestation. But most attesting shareholders will also be required to file federal ownership disclosure reports under our integrated ownership disclosure proposal, including an ex post recitation of instances in which they cast empty votes. There are federal criminal penalties for filing false reports, which constrain false federal filings. And it seems unlikely that many shareholders will falsely attest to economic ownership when voting, then truthfully report a divergence between voting and economic ownership in a later federal filing. So the attestations should be credible. If an attestation is false and this is later

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166 For empty voting by insiders—directly or through the corporation—the courts may already have the power to intervene. As the Delaware Supreme Court stated in *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1127 (Del. 2003), the Delaware courts "have remained assiduous in carefully reviewing any board actions designed to interfere with or impede the effective exercise of corporate democracy by shareholders, especially in an election of directors." Our proposal would ensure that the courts have this power for insiders, and would extend it to voting by outsiders.
discovered, the courts can decide on a case-by-case basis whether to require a new vote and what sanctions to impose.

We would address the situation where one person or entity controls several others who each hold shares in the same company, by requiring parent-level attestation. Otherwise, the attestation rule could be evaded.\textsuperscript{167}

We would apply the attestation rule only to large shareholders for several reasons. First, transaction costs will likely outweigh benefits for smaller shareholders. Second, smaller shareholders who hold more votes than economic ownership are likely to be simply hedging, not engaging in deliberate empty voting. Third, the empty votes of small shareholders are unlikely to affect many voting outcomes. Finally, additional burdens on individual investors will encourage even more passivity.

It is possible, but we think unlikely, that attestation, or another plausible, facially neutral charter amendment, would require changing NYSE rules, which state that voting rights "cannot be disparately reduced or restricted through any corporate action or issuance."\textsuperscript{168} The NYSE states that its voting rights policy "will be flexible, recognizing that both the capital markets and the circumstances and needs of listed companies change over time."\textsuperscript{169} It is more likely that attestation would require technical changes to implicate the federal proxy rules, given the SEC’s broad power to regulate the proxy process, including the form of proxies.\textsuperscript{170}

Disallowing votes raises a technical concern. One would not want disallowance of voting rights to cause companies to have trouble obtaining a quorum. Nor would one want disallowance to create implicit no votes, based on the approval needed for a particular decision. For example, a merger or a charter amendment requires approval by a majority of the outstanding shares. Disallowed votes should not count as no votes. A natural solution is to exclude nonvotable shares in determining the number of outstanding shares, in the same way that

\textsuperscript{167} Parent could, for example, arrange for subsidiary 1 to be long 1 million shares of company X, while subsidiary 2 is short 1 million shares. Parent is thus fully hedged, yet if attestation is not at the parent level, subsidiary 1 could vote its 1 million shares.

\textsuperscript{168} NYSE Euronext, Listed Company Manual § 313(A) (2007). Examples of such plans include time-phased voting (longer-term shareholders get more votes per share) and capped voting (a cap on the number of votes by a single shareholder).

\textsuperscript{169} Id.

Treasury shares, or shares held by a company's subsidiaries, are not treated as outstanding.\textsuperscript{171}

The difficulty comes in identifying nonvotable shares. One needs, in effect, to count the number of shares in each of five categories instead of the usual four: (1) yes votes; (2) no votes; (3) abstain (neither yes nor no, but counts toward a quorum); (4) non-votes of votable shares (does not count toward a quorum); and (5) the new category of disallowed votes (reduces the number of effectively outstanding shares). One approach would be to require shareholders who hold disallowed votes, when they vote and attest to economic ownership, to also attest to how many shares they hold for which votes are disallowed.\textsuperscript{172}

2. Voting with Negative Economic Ownership

We also believe that corporate law should intervene directly and bar voting in the extreme case of negative economic ownership. Possible holdings of related non-host assets aside, negative economic ownership gives the shareholder incentives to vote against the interests of other shareholders.\textsuperscript{173}

Corporate law does not generally police the reasons why shareholders vote as they do. Shareholders can vote based on their private interests, even if those diverge from corporate interests. For instance, employee shareholders can vote to preserve their jobs, at the expense of firm value, and diversified shareholders can vote to benefit their overall portfolio, rather than the company's interests, and a controlling shareholder can vote against a merger proposal that creates


\textsuperscript{172} A potential concern with a charter amendment approach is that the general potential for empty voting means that the vote on a charter amendment might itself be bought. We think this is an acceptable risk. Empty voting is still the exception and not the rule, and it is not clear why an attestation rule would be controversial enough to attract an empty voting effort, whether to support or defeat it.

\textsuperscript{173} We need not specify here the precise nature of those interests or of the company value at stake. For a discussion of three conceptions of the corporate objective and differences between actual and blissful shareholder wealth maximization and between shareholder wealth maximization and shareholder welfare maximization, see Henry T. C. Hu, Behind the Corporate Hedge: Information and the Limits of "Shareholder Wealth Maximization," J. APPLIED CORP. FIN., Fall 1996, at 39, 40-43, 48-50.

One can readily develop several justifications. First, if most shareholders have incentives to vote in ways that are likely to increase value and the cases where they do not are uncommon, it may not be worthwhile to worry about limiting the power to vote one's private interests. Second, it will often be hard to determine a shareholder's reasons for voting. Third, allowing controlling shareholders to vote as they please may offer rough justice on access to private benefits. Corporate law limits self-dealing, albeit not perfectly. Yet if private benefits were too low, controllers might decline to retain control, to the detriment of other shareholders, or might not take the firm public in the first place.\footnote{See Jens Dammann, Majority Freezeouts 16-17 (Univ. of Tex. Law Sch., Law & Econ. Research Paper No. 114, 2007), available at http://ssrn.com/abstract=1015082.} Fourth, there is value in speed and finality in determining voting outcomes.

None of these justifications is compelling for a shareholder who holds a negative economic ownership (a net short position) in company $X$. We propose that state corporate law should presume that such a shareholder is voting against the interests of other shareholders and disallow voting rights, thus leaving the decision to be made by other shareholders. The presumption could be rebuttable, to allow for the case in which a shareholder could show that his overall economic interest, including related non-host assets, was positive. Or it could be a flat rule, on the grounds that holding voting while holding negative net economic ownership is already uncommon, and the exception to the exception—negative economic ownership yet positive overall economic interest—is rare enough not to be worth addressing.

Such a rule is analogous to the rules in many countries, though not the United States, which require majority of minority approval for
freezeouts or related party transactions, thus limiting voting rights to unconflicted shareholders. Indeed, even without a legislative amendment, one can imagine courts using their equitable powers to disallow voting by shareholders with negative economic ownership. This situation is analogous to cases limiting voting by directors whose personal interests conflict with the corporation's interests. Current case law is limited to directors and officers, who have an explicit fiduciary duty to the corporation. But one can imagine the courts creating a limited fiduciary duty on the part of shareholders not to vote in this situation, much as they have created a limited fiduciary duty of controlling shareholders in a freezeout.

Our proposal to bar voting by persons with negative economic interests is similar in spirit to the Hedge Fund Working Group proposal to bar voting of shares in which market participants had no economic interest. The group felt that this might result in votes being exercised against the best interests of the lender. In contrast, our proposal only applies to those with negative overall economic interests. However, our proposal is not limited to share lending.

3. Voting by Record Owners: Extension to OTC Equity Derivatives

The case of empty voting by shareholders with zero economic ownership deserves special attention because it is common and, in part, already regulated. Record ownership decouples economic from voting ownership. Our legal system has responded by partially recoupling the two. Economic owners can provide voting instructions, which record owners must follow; if no instructions are given, the record owner can vote on routine matters but not major matters.

These rules can provide precedent for a broader effort to reconnect voting rights to economic ownership when financial innovation has severed them. Consider, for example, a derivatives dealer who

176 See Warner Fuller, Restrictions Imposed by the Directorship Status on the Personal Business Activities of Directors, 26 WASH. U. L.Q. 189, 189 (1941) (discussing the restrictions of corporate directors' "freedom to engage in purely personal business activities"); cf. Golden Rod Mining Co. v. Bukvich, 92 P.2d 316, 320 (Mont. 1939) (addressing the situation of an outside director who was a competitor).


178 Jonathan Cohen, Negative Voting: Why It Destroys Shareholder Value and a Proposal To Prevent It, 45 HARV. J. ON LEGIS. (forthcoming 2008), proposes a private right of action for shareholders harmed by voting with negative economic interest. In our view, this remedy is too mild, even assuming effective disclosure, because harm will often be hard to show.
holds matched shares to hedge the short side of an equity swap. As we discussed, under common market practices, the long swap holder often has informal rights either to unwind the swap and obtain and vote the matching shares, or to instruct the dealer on how to vote. Disclosure aside, these informal rights are analogous to the rules governing record owners. We would make them formal: Dealers who hold matched shares to hedge a short equity swap position with a known counterparty should be treated the same as record owners, and should pass voting rights on to the counterparty. Similar rules should apply in other situations in which a dealer holds matched shares to hedge another equity derivatives position where a single counterparty with economic ownership can be identified.

Some caveats and exceptions: This proposal would not require dealers to hedge in any particular way; it would apply only if they hedged through matched shares. This proposal would not apply if a dealer hedges its risks on a portfolio basis rather than a transaction basis. One might need a de minimis rule, to ensure that a dealer can't vote a million shares by holding one share unhedged. Finally, if the counterparty is the issuer of the shares or an affiliate of the issuer, the dealer should simply not vote.

Record owners currently need not investigate whether the person for whom they hold shares is hedged. We would not change this. Record owners should pass votes on to apparent economic owners based on their own knowledge. We would rely on the provisions discussed above (charter amendments and denial of voting rights to persons with negative net economic interest) to operate directly on the apparent economic owner.

This transfer of voting rights from derivatives dealers to their customers would limit investors' ability to hold large-scale hidden (morphable) ownership, even under existing U.S. disclosure rules. Reporting on Schedule 13D and Schedule 13G is largely triggered by access to voting rights. If derivatives dealers transferred voting rights to long equity swap holders, the holders would have clear rights to the votes on the matched shares, so these shares would count toward the 5% trigger. However, the transfer rules would not affect reporting on Form 13F. This proposal would also substantially limit corporate soft parking.

179 For example, a dealer may hold shares to hedge an overall book of options positions, with calls held by some clients and puts held by others. In this situation, economic ownership will be split, and there may be no obvious person to pass voting rights to. The rights should then remain with the derivatives dealer. Our proposal focuses on situations where the locus of economic ownership is clear.
Consider next other cases of zero economic ownership. The shareholder may not have bad incentives, it merely has no incentives. Should state law prevent voting? Our answer is a cautious "no." In effect, we need to draw a line somewhere between two classes of situations: (1) positive economic ownership, where the default rule is the right to vote, but we would allow companies to limit empty voting through a charter provision; and (2) negative economic ownership, where we believe the case against voting is clear enough so that the corporate law should bar voting. Zero economic ownership (or, a bit more broadly, economic ownership that is small in relation to voting rights) falls right on the line. We address above zero economic ownership by record owners and derivatives dealers. We would let the remaining instances lie.

4. Voting by Record Owners: Proportional Voting if No Instructions

Record owners sometimes receive more voting instructions from economic owners than they can honor—which creates the overvoting problem. But often they receive fewer instructions than they hold votes. Broker-dealers are barred from voting for many important decisions; banks are not covered by these rules but apparently routinely do not vote unless instructed. The NYSE has proposed to extend the ban on broker-dealer voting to routine director elections effective for annual meetings in 2008; at this writing, the SEC is reviewing this proposal. When not barred from voting, record owners can vote as they see fit, and usually support management's recommendations.

An alternative approach would be for record owners, when they have more votable shares than instructions, to vote all shares in proportion to the instructions they receive (assuming, as is usually the case, that the instructions represent a reasonable fraction of the shares). This would somewhat overweight the instructions that shareholders convey, but creates no obvious incentive problems. At the

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margin, the prospect of overweighted voting might induce more economic owners to vote. The Securities Industry and Financial Markets Association—a trade association representing most major securities firms, banks and asset managers—encourages its members to adopt proportional voting; some major broker-dealers have already done so.\footnote{See Letter from Donald D. Kittell, Executive Vice President, Sec. Indus. & Fin. Mkts. Ass'n, to Nancy M. Morris, Sec'y, Sec. Exch. Comm'n 2 (Mar. 30, 2007), available at http://www.sec.gov/comments/s7-03-07/s70307-20.pdf.}

In keeping with our overall incremental approach, we would limit this approach to instances where broker-dealers can currently vote. But it may well be extendable to elections in which broker-dealers currently can vote only shares on which they receive voting instructions.

5. Empty Voting by Insiders

Directors, officers, and controlling shareholders can also engage in empty voting, either directly or by inducing corporate action. We have already discussed ESOPs. The fiduciary duty rules and cases which apply there also apply to other efforts by insiders to use empty voting to resist a takeover bid.\footnote{See supra Part I.C.3.}

Here, we address insider empty voting outside of the takeover context. Corporate officers and directors are fiduciaries, so the duty of loyalty offers a natural framework to discuss this practice. The greater rigor with which courts police shareholder elections outside the takeover context makes it possible, even likely, that company officers or directors would breach the duty of loyalty if they used corporate assets or the promise of future business to procure votes. In the \textit{Hewlett v. Hewlett-Packard} proxy fight, for example, major shareholders, led by Walter Hewlett, opposed a merger between Compaq and HP, on the grounds that HP was overpaying. HP's managers barely obtained a majority shareholder vote for the merger. Hewlett then sued, claiming that HP's management had procured votes from Deutsche Bank through promises or threats related to future business dealings between the two companies.\footnote{Hewlett v. Hewlett-Packard Co., No. 19513-NC, 2002 WL 818091, at *1, *8-9 (Del. Ch. Apr. 30, 2002).} HP's managers defended on the grounds that they had made no promises or threats, but had merely sought vigorously to present their case on the merits. Chancellor Chandler concurred.\footnote{See id. at *9 ("During the conference call [between Hewlett-Packard and Deutsche Bank], no one from HP used any threats or inducements regarding future
If HP's managers had procured votes through a promise or threat relating to future business, that would presumably both violate management's fiduciary duty and constitute classic vote buying. Both sides in the HP case assumed this was improper. We believe that the same conclusion should apply to corporate stock parking, whether hard or soft. The remedy should be that the counterparty should not vote.

Suppose now that the insiders engage in empty voting directly, rather than through parking by the company. Partially empty voting by insiders is already common; many executives who hold zero-cost collars or other hedges are partially empty voters. Our tentative view is that if directors and officers engaged in new vote buying for their personal accounts in contemplation of a specific vote, say, by buying shares while hedging, the breach of fiduciary duty is the same as with corporate soft parking—the insiders are controlling votes on shares they do not economically own—and the outcome should be the same.

What then if the insider holds a partially empty position, established some time ago, without regard to a particular vote? We would, for now, leave this situation to be addressed, if at all, by corporations themselves. To be sure, the ability to buy votes in advance of a particular vote might lead insiders to do so, and then propose no such amendment. Thus, if large scale insider hedging becomes common, this issue might need to be revisited.

C. Strategies Affecting the Share Lending Market

1. The Importance of Share Lending and Recent Industry Developments

A second family of regulatory interventions would focus on supply and demand for share borrowing and lending. Share lending plays a key role in decoupling. First, the very act of borrowing decouples economic ownership from voting ownership. Tax differences between the return on shares and the mirror return paid by the borrower to the lender aside, borrowing of shares is really borrowing of votes. In record date capture, a share borrower simply keeps the shares and votes them. Other empty voting strategies often rely on share lending as well. In particular, the strategy (buy shares, hold short equity swaps) will often have as a counterparty a derivatives dealer who is short shares (having borrowed them) and long the equity swap.
The cost of share borrowing is quite low. A typical borrowing cost is around 20 basis points per year, or less than 0.1 basis points (0.001%) per day. Thus, unless prices are higher for borrowing on a record date, one can borrow the votes on $1 billion of shares for less than $10,000 ($1 billion x .001% = $10,000).

With regard to scale, the stock loan market is huge and growing. In the United States alone, the volume of outstanding stock loans at mid-year 2005 was about $1.5 trillion. Most stocks can be borrowed. During the second quarter of 2007, $3.6 trillion of U.S. equities were available for borrowing from just 16 lending banks, based on a survey by the Risk Management Association (RMA). These shares represent roughly 17% of the combined market capitalization of the NYSE and NASDAQ. Additional shares would be available from other sources, including broker-dealers who hold shares for retail investors or hedge funds, and from institutional investors who run their own lending programs. A knowledgeable source advised us, as a conservative "guesstimate," that, in normal (non-takeover) circumstances, roughly 20% or more of the shares of a typical large U.S. publicly held company can be borrowed. In the U.K, one source suggests that for large firms in the Financial Times Stock Exchange (FTSE) 100 Index, as much as 50% of their shares are generally borrowable.

On the lending side, stock lenders know that their vote is unlikely to swing an election. Moreover, lenders who recall shares on record dates—thus forcing borrowers to find an alternate lender, perhaps at a difficult time if other lenders also behave this way—are less reliable lenders, and are likely to be chosen last when borrowers choose their lenders from among a normally ample supply or to receive lower lending fees. To be sure, if enough institutions recalled and voted shares,

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189 Peter Butler, Founder & CEO, Governance for Owners, Address at the International Corporate Governance Network Conference: Creating Value—Building Trust (July 7, 2006) (PowerPoint slides on file with authors) (providing data on shares borrowed as a percentage of shares outstanding and as a percentage of borrowable shares; one can combine the two percentages to estimate borrowable shares as a fraction of shares outstanding).
a separate market might develop for lending shares that would be recalled on record dates, with a lower borrowing rate. Such a market does not yet exist. A different balance of supply and demand might also cause a spike in the price of borrowing on the record date, which would then constrain demand, but that too has yet to happen.

2. Safe Harbor for Voting Instead of Lending; Lending Disclosure

How might we change the current equilibrium—in which share borrowing for empty voting is easy and lender recalls of shares for voting are the exception—without significantly disrupting the valuable, nonvoting reasons for share borrowing, including hedging and short-selling?

Regulators already encourage institutions to recall and vote lent shares. The SEC does so for mutual funds; the Department of Labor does so for ERISA pension funds. But these are only nudges. Moreover, the record date, and hence the need to decide whether to recall shares, often occurs before the voting agenda is known. Indeed, it sometimes takes effort even to learn the record date before it has passed. These regulatory nudges appear to have limited effect on lending behavior. They may, however, provide an implicit safe harbor for institutions which prefer to vote their shares rather than lend them, against a claim by their clients or beneficiaries that the institution breached its fiduciary duty by not maximizing lending income. The reliability of the safe harbor is uncertain; we know of no cases challenging decisions to vote shares instead of lending them, or vice versa.

An initial step would be to create a firm regulatory safe harbor, for all major classes of institutions, if they vote shares rather than lend them. A safe harbor is appropriate because for major shareholders, voting is plausibly socially optimal, even if not privately optimal for any

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190 We discuss these efforts in Hu & Black, Decoupling I (Law Review Version) (2006), supra note 1, at 899-901.
191 Companies must inform record holders (under Exchange Act Rule 14a-13, 17 C.F.R. § 240.14a-13 (2007)) and exchanges (under exchange rules) of record dates in advance. They normally do not provide advance notice to shareholders. However, institutions can learn record dates from stock exchanges (the NYSE publishes them in a weekly circular) or from specialized services that provide this information. Jennifer E. Bethel, Gang Hu & Qinghai Wang, Institutional Investor Activism: Evidence from Voting and Daily Trading Around Mergers and Acquisitions 6-7 (Working Paper, 2007) (on file with authors).
one shareholder due to the low likelihood that one's vote will be determinative.

A further disclosure step, which we recommended in Part III, would be to require institutions to disclose the fraction of shares they voted, could have voted but did not, and the fraction lent. This disclosure could create soft pressure on some institutions (especially mutual funds and public pension funds) to vote instead of lend, or at least to explain their lending decisions.\footnote{A modest extension, which on balance we would not adopt, would be a “vote or explain” rule, under which institutions would have to either vote or explain why they did not. We expect that the explanations would soon become boilerplate.}

We do not recommend that regulators require institutions to recall and vote lent shares. For many routine votes, this would impose costs, for little benefit. Moreover, widespread recall of lent shares could create an “artificial” squeeze on the supply of lendable shares, which might undermine the market for short-selling and for hedging strategies which employ borrowed shares. Also, many institutional investors want to stay on good terms with company managers. Such a dynamic could explain why, when acquirer shareholders must vote on acquisitions, the acquisitions are almost invariably approved, even if stock price reactions suggest that the acquirer has overpaid.\footnote{See Ehud Kamar, Does Shareholder Voting on Acquisitions Matter? 37 n.32 (Working Paper, 2006), available at http://law.bepress.com/alea/16th/art64; see also Bethel, Hu & Wang (2007), supra note 191, at 14-15.}

The fear that mutual fund managers would be more likely to cast pro-management votes if their votes were disclosed created controversy over SEC rules which require this disclosure.\footnote{See Cremers & Romano (2007), supra note 151.} Institutions’ willingness to be persuaded could help to explain why, when a vote is close, managers can often round up just enough yes votes to win.\footnote{See Yair Listokin, Management Always Wins the Close Ones (Working Paper, 2007), available at http://ssrn.com/abstract=980695. Soft parking may provide an alternative explanation; if managers anticipate a close vote, they may arrange for votes to be held by friendly hands, and then call in enough votes to win once they see how the voting is going.} Meanwhile, public pension funds are not beholden to companies, but can have political motives. Thus, it is not clear that forcing institutions to vote is the right approach, when the alternative might often be for the institutions to lend shares to unconflicted hedge funds.

We do recommend, however, that regulators address the practical problem that institutions’ efforts to recall lent shares not infrequently
fail.\textsuperscript{196} Strong regulatory encouragement, and perhaps a requirement, that institutions have the technical ability to recall shares in order to vote would prompt technical changes in the ways shares are lent, which would facilitate both recall and disclosure of lending activity.

At present, market participants are embedded in an overall system in which recall is sometimes difficult. Indeed, some institutions currently do not lend shares in part because of difficulties in recalling shares.\textsuperscript{197} Change will take collective action, which institutional lenders may not have sufficient incentives to undertake. An analogy is to regulatory forcing of shorter share settlement periods. The regulation should specify the minimum period needed to achieve recall. We expect that 48 hours will be enough, and 24 hours might well suffice as the regulations develop, even if not immediately.

We also recommend that broker-dealers, who lend shares held in margin accounts in street names, should be required to hold enough shares on the record date so they can honor the voting instructions they expect to receive, based on past experience with client voting instructions. The regulations can specify a safety margin or a maximum acceptable probability of not honoring all instructions. For enforcement, we would require broker-dealers to, first, notify their clients if voting rights are limited because the broker lent out too many shares, and second, publicly disclose instances in which it could not honor voting instructions because it had lent too many shares. We would limit this rule to shares held in individuals' and other noninstitutional accounts. Institutional investors can fend for themselves and decide whether and on what terms to lend their own shares. Under this approach, when broker-dealers lend shares, these shares would otherwise likely have gone unvoted. The lent shares will often be voted by the new holder of the shares. The overall proportion of voted shares will rise, and the impact of rational apathy, which leads some shareholders not to vote, will be modestly reduced.

Broker-dealers should also be required to implement internal procedures so they know how many votes they hold, know how many voting instructions they have received, and can reliably vote only the shares they are entitled to vote, thus avoiding overvoting. This would

\textsuperscript{196} We discuss this and other problems associated with stock lending practices in Hu & Black, Decoupling I (Law Review Version) (2006), supra note 1, at 895-98.

\textsuperscript{197} In a recent survey by Institutional Shareholder Services, 31\% of the institutions who do not currently lend shares indicated that they would do so “if there were an automated way to identify meetings for which they wanted to vote and to recall the shares to retain voting rights.” Inst’l S’holder Servs. (2007), supra note 149, at slide 3.
apply to all the shares they hold of record, for both individuals and institutions. The regulatory push here is needed because broker-dealers may have insufficient incentives to get this right on their own.198

If one sharply narrows the time gap between record date and meeting date, as we recommend below, broker-dealers will receive voting instructions before the record date. They could then be required to recall enough lent shares to honor all instructions received by a set time before the record date, plus any instructions they expect, based on experience, to receive between then and the record date. One might also require them to adopt procedures to rapidly process instructions that come in shortly before the record date.

3. Lending to Empty Voters: Know-Your-Customer's-Purpose Rules

There are already some limits on lending for record date capture. In the United States, Federal Reserve Board Regulation T limits the purposes for which broker-dealers who don't deal with the general public can lend shares. These broker-dealers must make a good faith effort to determine the borrower's purpose and cannot lend shares for voting purposes.199 However, even for covered broker-dealers, Regulation T would not prevent a transaction in which a client acquires votes without economic ownership through a combined share purchase and equity swap. Yet, as we discussed in Part I.C, this transaction is a full substitute for a direct share loan. In the U.K., market norms also limit record date capture. But here too, these norms apparently do not impede the long shares, short equity swaps equivalent.200

198 For an extreme example where a broker-dealer routinely overvoted and apparently didn't try to limit its voting based on the shares it was entitled to vote, see In re Deutsche Bank Securities Inc., NYSE Request for Review of Exchange Hearing Panel Decision 05-45, at 2 (Feb. 2, 2006), available at http://www.nyse.com/pdfs/05-045.pdf (NYSE fines Deutsche Bank based on stipulated facts, including overvoting "on numerous occasions").


200 See, e.g., BANK OF ENGLAND, SECURITIES BORROWING AND LENDING CODE OF GUIDANCE § 7.4 (Dec. 2004) (stating that there is a "consensus... in the market that securities should not be borrowed solely for the purposes of exercising the voting rights at [a shareholder meeting]"), available at http://www.bankofengland.co.uk/markets/gilts/stockborrowing.pdf; PAUL MYNERS, SHAREHOLDER VOTING WORKING GROUP, REVIEW OF THE IMPEDIMENTS TO VOTING UK SHARES 12-13 (Mar. 2005), available at http://www.investmentuk.org/press/2005/20050314-01.pdf (Myners Commit-
We recommend expanding the reach of these rules and norms. They should apply to all banks, broker-dealers, and other derivatives dealers. Moreover, they should apply not only to share borrowing, but also to matched share purchases and equity swaps, and other multi-element transactions which are economically equivalent to share borrowing. To be sure, an empty voter could likely still achieve the same end by using different dealers for the two legs of a transaction, but this would increase trading and market impact costs.\textsuperscript{201} Our proposed expansion of the current know-your-customer’s-purpose rules will impose some transaction costs and could delay some share borrowing transactions. Yet for most of the year, borrowing for empty voting purposes is unlikely. One might therefore want these rules to apply primarily, or require more careful checking of the borrower’s purpose, during the period directly preceding a record date.

One might ask, if we bar banks, broker-dealers, and other derivatives dealers from lending to empty voters, should other institutions be subject to similar limits on lending? Our answer is no. The entities we propose to regulate usually have little or no economic ownership of the underlying shares and hence no reason to care how their borrower votes. Other investors are usually economic owners, and could be rationally deciding to lend their votes to others, who may be more informed or less conflicted voters.\textsuperscript{202}

Suppose that most share lenders were to recall and vote their shares on record dates. One likely market response would be a higher lending price for the record date. If the overnight lending price were high enough, some lenders might then decide whether to lend or vote depending on that price. Limited availability of borrowable shares, or a high-enough borrowing price, would also affect many hedging strategies, as well as short selling, which depends on the availability of

tee report, advocating greater industry safeguards to address stock lending); \textit{cf. HEDGE FUND WORKING GROUP (2007), supra note 129, at 61 (recommending a ban on voting borrowed shares without economic interest, but not addressing the long shares, short equity swaps equivalent)}.\textsuperscript{201}

As we discuss above, if an empty voter both buys shares and takes the short side of an equity swap with a single dealer, the dealer can hedge by selling shares short to the hedge fund; thus, there may well be no direct market impact. If the empty voter must buy shares from one dealer and hedges with another, both sides must engage in market transactions, incurring trading and market impact costs. The two dealers will enter into offsetting transactions, but their actions will not be coordinated, so each side’s trades will move the market to some extent.\textsuperscript{202}

borrowed shares. In theory, widespread recall of borrowed shares could create a one-day short squeeze. Moreover, right now, the market imposes a large cost on lenders who recall and vote shares—they become less predictable and hence less desirable lenders. One possible solution to both problems would be to allow naked shorting, for the record date alone, for borrowers who have already established positions (say, for a minimum number of days), so that the short seller could simply return the borrowed shares, and reborrow right after the record date, without having to unwind any other transactions. We raise this as a possibility, without recommending it, because we do not believe we understand the implications of naked shorting well enough, and there is no immediate need for this step.  

4. Recent Changes in Share Lending Practices

Recent publicity on the role of share lending in empty voting may be leading some lenders to voluntarily change their practices. For instance, some institutional investors are now hiring independent monitors to try to ensure that securities loans go to "reputable, responsible borrowers," rather than to empty voters who might act against the interests of long-term shareholders. These moves by individual institutions are helpful, but may have limited effect unless they are formalized in an explicit industry self-regulatory agreement, and address both direct lending for record date capture and indirect equivalents. Such an expanded self-regulatory effort might gain support from the Hedge Fund Working Group report, which recom-

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203 If naked shorting were to be allowed, who has voting rights—the lender who has recalled the shares or the counterparty to whom a short seller has sold shares? The only realistic answer is both. In an anonymous market, the counterparty cannot even be found. This does not trouble us. Both are economic owners. Both have the right incentives, subject to their other holdings. One loses some ex ante certainty about the number of votable shares, but this is not a significant departure from the current environment, when the number of shares that will be voted is unknown ex ante.


205 Gerut (2007), supra note 204.
mends a regulatory ban on the use of borrowed shares for empty voting purposes.\(^{206}\)

D. Strategies Focused on Voting Architecture

The new vote buying has put stress on a "voting architecture" developed at a time when information about the voting agenda, and the votes themselves, were on paper, which moved slowly around a large country long before the emergence of modern decoupling strategies. That voting architecture is greatly complicated by the current need to embed it within a system of record ownership of most shares, developed to facilitate share trading and payment of dividends.

It is time to rethink the voting architecture in any case to reflect instant electronic access to the voting agenda, the potential for instant delivery of votes, and the potential for direct voting of shares by economic owners. The extra stress on the system due to new forms of decoupling might provide the impetus for that broader rethinking. We propose below a number of reforms—some technical and narrow, others involving major restructuring of the current architecture.

1. Technical Changes

Several technical changes to current practices would facilitate voting by economic owners. First, the voting agenda should be available before the record date, and the record date should be publicly known before it has passed. This will ensure that share lenders know what they will be voting on when they decide whether to recall lent shares, and know when they will have to recall the shares. The SEC could use its "proxy rules" authority to require companies to announce the record date and a tentative agenda, say five business days before the record date.

Second, dividend record dates and voting record dates should be split. Right now, many companies combine them. Some investors will borrow shares on the dividend record date as part of a dividend capture strategy. If the two record dates coincide, the dividend capture investor also acquires votes, yet is an empty holder who will likely not exercise them. There is no substantive reason for the two dates to coincide. The SEC could use its proxy rules authority to require that the two dates be separated, say by at least five business days.

Third, when overvoting occurs, the record owner should be treated as voting the number of shares it is entitled to, with yes, no, and abstain votes reduced proportionately. The current Delaware approach, in which a million valid votes are tossed out if a record owner reports 1,000,001 votes, has nothing to recommend it, at least nothing we can think of.\textsuperscript{207} This would require a change in Delaware case law on how tabulators should handle overvotes, but no change in the Delaware corporate statute, which already provides a procedure for tabulators to reconcile overvotes.\textsuperscript{208} The SEC could also prevent most overvoting by requiring record owners to verify the number of shares they are entitled to vote before voting and vote only that number of shares, in proportion to voting instructions received.

2. Direct Voting by Economic Owners

The current voting system routes many votes by economic owners, clumsily, with error and delay, through record owners. This is not inevitable. If we want to get voting right, we could greatly simplify the current system by getting record owners out of the middle, and having votes travel directly from economic owners to the company or to an outside vote tabulator. We assume below that a vote tabulator receives the votes, but the mechanics do not depend on this assumption.

This is not a new idea. Jay Brown suggested something similar in 1988, and other scholars have done so more recently.\textsuperscript{209} Russia implemented a similar approach in 1995.\textsuperscript{210} The Business Roundtable

\begin{footnotesize}
\textsuperscript{207} See Seidman & Assocs., L.L.C. v. G.A. Fin., Inc., 837 A.2d 21, 25-28 (Del. Ch. 2003) (invalidating 230,000 otherwise valid votes because of a 0.3% overvote). Vote tabulators can sometimes resolve overvotes by contacting the record owner and getting corrected data, but this effort is sometimes not made and, even when made, sometimes fails.

\textsuperscript{208} See DEL. CODE ANN. tit. 8, § 231(d) (2001) (providing that "inspectors may consider other reliable information for the limited purpose of reconciling proxies and ballots" where overvoting is suspected).


\end{footnotesize}
DECOUPLING II

proposed something similar in 2004.\textsuperscript{211} Any country with a single central depository most likely has direct voting as well.\textsuperscript{212} It would mean that record owners would have to tell companies who their economic owners are. However, most major shareholders are already known due to ownership disclosure rules. Firms know the identities of a fair number of other shareholders under SEC “OBO/NOBO rules,” which require record owners to ask economic owners whether they object to disclosure of their identity to companies, and to disclose the identities of non-objectors.\textsuperscript{213} Shareholders who wanted to remain anonymous could still hold through shell companies, or through nominee accounts at broker-dealers.

If anonymity were a serious concern—more than we believe it to be—companies could be required to use SEC-licensed vote tabulators, and record owners could provide information about economic owners only to tabulators, who would not disclose it to companies. This would be similar to the confidential voting procedures already used by many companies. If a company does not use a tabulator, or otherwise learns about votes as they come in, presumably a dissident should have the same access to this information.

Such a system is compatible with record ownership, but would be likely to affect share lending. For example, record owners might need to lend from identified accounts, instead of from an unidentified pool. Or record owners would need to tell tabulators something like “the following economic owners hold in aggregate x votable shares; please limit their voting rights accordingly.” If voting is direct, there could be pressure to advise margin account holders if some of their votes were not counted because the corresponding shares had been lent; that disclosure could reduce willingness to hold shares in margin accounts. Tracing the impact of direct voting on share lending is beyond the scope of this Article.

Direct voting would require changes in both SEC and stock exchange rules. But it is not technically difficult; indeed, it is simpler

\textsuperscript{211} See Business Roundtable, Request for Rulemaking Concerning Shareholder Communications (Petition 4-493) (Apr. 12, 2004), available at http://www.sec.gov/rules/petitions/petn4-493.htm (recommending that the SEC “consider requiring brokers and banks to provide companies with contact information for all beneficial owners, and permit companies to mail proxy materials directly to all beneficial owners”).


than the current system. It builds on technology that is already in place under the NOBO rules. Its greater simplicity should reduce the breakdowns that plague the current system, in which valid votes are not counted.

3. Minimizing the Gap Between Record Date and Meeting Date

For a typical firm, the time gap between the record date and the meeting date is about a month. That time used to be needed—for paper information about the meeting and requests for voting instructions to make their way through layers of record holders to the economic owner and back up. Today, that delay is largely unnecessary. Economic owners can be notified about the meeting by e-mail, obtain information about the meeting electronically, either from the company or the record owner, and give voting instructions online. Moreover, trading velocity has increased, and consequently so has the divergence between who holds shares on the record date and who still holds them on the meeting date; today, roughly 10% of a typical firm’s shares will trade during this period. Some of these will be roundtrips, but still a significant mismatch between voting rights and economic rights is likely. The mismatch could be higher for an important vote, because investors will trade in anticipation of the voting outcome. The time gap also makes possible the strategy employed in Henderson Land, of borrowing on the record date, voting to decrease share price, and profiting by selling short before the meeting date.

Yet it is straightforward to compress the time between record date and meeting date. Suppose first that economic owners cast votes directly with tabulators. A shareholder could say “vote all my shares yes,” and this would simply happen. The shareholder could also split votes by saying, for example, “vote 60% of my shares yes, 30% no, and 10% abstain.” Or the shareholder could say “vote 1000 shares yes,” and if it only holds 900 votes, then only 900 will be counted. If the shareholder says “vote 700 shares yes and 300 shares no,” but owns only 900 shares, the tabulator would honor voting instructions pro rata, similar to our proposal above for overvoting. Under this ap-

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DECOUPLING H

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The time gap between record date and meeting date turns on the vote tabulator's ability to verify voting rights, and match these against voting instructions. The tabulator will receive and verify votes as at present, as they come in, and enter them into a computer database. The tabulator will then receive ownership data from the firm and record holders, match the two, and report voting outcomes. In principle this could likely be done overnight, based on ownership as of the close of the prior trading day. At least initially, it might be more practical to allow an extra business day. Thus, voting for a Wednesday meeting would be based on ownership at Monday's close, and so on.

International comparisons suggest that this time frame is reasonable. The U.K. has compressed the time between record date and meeting date to two business days; Germany may effectively have a two-business-day period as well; France has three business days; and Spain has five days. A recent EU Directive contemplated member states eliminating record dates entirely and allowing electronic voting at meetings, as long as shareholder identities can be established.

215 If voting rights are limited by reference to economic ownership, then major shareholders who voted before the record date and attested to economic ownership at that time, would presumably need to reattest, or correct a prior attestation, as of the record date. One form of attestation could be "I have, and at the record date will have, economic ownership the shares for which I have voting rights," thus allowing for unhedged trading between the attestation date and the record date.

216 In the U.K., see Companies Act, 2006, c. 46, § 327(2) (Eng.). German law does not use the concept of a record date for registered shares; shareholders as of the meeting date can vote. Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBl. I at 1089, last amended by Gesetz, July 16, 2007, BGBl. I at 1330, § 67(2) (F.R.G.). Thus, the minimum time is set by the share trading settlement period, currently two business days. In practice, a somewhat longer period is sometimes needed to allow the company to update its share register. UWE HÜFFER, AKTIENGESETZ 334 (7th ed. 2006). Germany also allows bearer shares; for these shares the time gap is three weeks. Aktiengesetz § 123(3). On the French system, see Decree No. 06-1566 of Dec. 11, 2006, Journal Officiel de la République Française [J.O.] [Official Gazette of France], Dec. 12, 2006 (amending Code de Commerce art. R225-85); Jean-Paul Valuet, Le décret du 11 décembre 2006 sur les sociétés commerciales, 2007 REVUE DES SOCIETES 227, 233-34. On Spain, which uses a two-level dematerialized system of shareholding with record owners as the first level and economic owners as the second level, see Kahan & Rock (2007), supra note 158, at 36. See also Nathan (2007), supra note 158, at 8 (proposing to compress the time between record and meeting dates).

217 Council Directive 2007/36, art. 7.2, 2007 O.J. (L 184/17) (EC), allows companies to dispense with a record date if they can identify shareholders on the meeting date. Article 8.1-2 of the Directive requires companies to offer shareholders direct
This would require amending state corporate laws to eliminate the current minimum time gap between record date and meeting date (ten days in Delaware\textsuperscript{218}). The company should still be required to provide information about the voting agenda in advance of the meeting (a ten-day minimum period seems reasonable).\textsuperscript{219} Under our proposal, voting would largely, perhaps completely, precede the record date. Thus, one would also need to amend state corporate law to allow voting instructions which do not specify the number of shares to be voted, such as "vote all my shares yes," and to allow proportional allocation of votes if a shareholder casts a number of votes that exceeds his actual voting rights.\textsuperscript{220}

E. The Substance of Voting Procedure: Last-Minute Scrambles for Votes

Compressing the period between record date and meeting date will have substantive implications for how proxy contests are carried out. If the record date is established well before the meeting date, then ownership is fixed. For a contested issue, both sides can lobby voters, but they can no longer simply buy shares and accompanying votes. The time for that will have passed. Under our proposal, in contrast, shares can be bought—and then voted—until very close to the meeting date.

We see this as generally fine, as long as the voters are real, rather than empty. But it could be problematic if some safeguards are not put into place. First, insiders often have private knowledge of how the voting is going. They should not be able to use that information to buy just enough shares, just in time, to win a close contest. Managers usually win the close votes already.\textsuperscript{221} Adding last-minute share buying to their arsenal will not improve matters. Thus, we believe that section 16(b) insiders (directors, officers, and 10\% shareholders), and the
company itself, should be barred from buying and then voting shares during a period just preceding the record date, say five business days. The same rules could apply to explicit outside proxy contestants.

We would still allow the contestants to urge their friends to buy and vote shares—indeed, it is hard to see how one could prevent this. But that raises a second risk. Buying real shares is expensive, but buying empty votes is cheap. Unless we have good rules in place to deter empty voting, the quality of elections might decline. Thus, this proposal assumes that we also implement the anti-empty-voting proposals discussed above.

V. EXTENSIONS OF THE DECOUPLING FRAMEWORK

We briefly discuss here several implications and extensions of our decoupling analysis: decoupling of shareholder rights and obligations beyond voting and economic ownership rights and disclosure obligations (Section A); debt decoupling (Section B); and the potential for return of street sweep takeover bids (Section C).

A. Other Shareholder Rights and Obligations

1. Unbundling Shareholder Rights

In Decoupling I and in the bulk of this Article, we focused on two shareholder rights—“economic ownership” (the right to receive the economic return on shares) and voting rights—and one obligation—the obligation to disclose large ownership stakes. We also did not unpack the components of economic ownership. But shareholders have additional rights, large shareholders can have additional obligations, and economic ownership can be decomposed into smaller components.

We begin here to discuss that further set of rights and obligations, and the associated potential for unbundling. Empty voting, hidden ownership, and morphable ownership are important uses of decoupling, but they are not exclusive.

Shareholders who have full ownership of shares generally have at least the following rights:

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they benefit from fiduciary duties of directors and officers, including the understanding that directors and officers should act in the shareholders' interest, even if shareholders have only limited ability to force this outcome, beyond the power, flowing from voting rights, to replace directors;

- the right to sue, both derivatively and directly, to enforce the fiduciary duties of directors and officers;
- the right to inspect the company's books and records;
- the right to present resolutions at a shareholder meeting under state corporate law, and to include resolutions in the company proxy statement under federal securities law;
- several rights that can be seen as components of economic ownership:
  - appraisal rights;
  - rights to receive dividends;
  - rights to be paid in liquidation (after everyone else); and
  - preemptive rights to acquire additional shares, in an offering which involves preemptive rights.

Some of these rights are inherent in longstanding concepts of what it means to own shares; one might call these "embedded rights." Others are of more modern vintage. For each, one must ask: How can this right be decoupled from others? What impact does decoupling of some rights, such as decoupling of economic ownership from voting ownership, have on other rights? Full exploration of these issues is beyond the scope of this Article, but we sketch here some elements of the complex landscape.

**Inspection rights.** Some other rights will follow voting rights, without regard to economic ownership. In Delaware, for example, the

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223 See, e.g., Hu (1991), supra note 214, at 1288-1300 (proposing the concept of shareholder "maximization rights").

224 On shareholder rights to sue for fiduciary breaches, see, for example, MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 258-75, 912-1039 (9th ed. 2005).


227 See DEL. CODE ANN. tit. 8, § 262 (2001) (appraisal rights); id. § 170 (dividends); id. § 271 (liquidation).
courts have allowed "empty inspecting" of the company's books by a person with no net economic ownership.228

Lawsuit rights under corporate law. In Delaware, for voting rights, only formal record ownership counts. In contrast, a shareholder who holds shares indirectly through a record owner can bring a lawsuit. Here, economic ownership suffices. Moreover, the court will not ask whether an apparent economic owner has hedged its position. "Empty suing" is permitted.229

Lawsuit rights under securities law. In federal securities cases, economic ownership suffices. A holder of equity swaps is a proper plaintiff in a securities class action under Exchange Act section 10(b).230

Shareholder resolution rights. Under Delaware law, only shareholders can attend a shareholder meeting and present resolutions.231 However, a record owner, on request, will provide a proxy to an economic owner who wishes to attend and present a resolution. In contrast, for shareholder proposals included in the company proxy statement under Rule 14a-8, beneficial ownership in the 13D sense counts. Under SEC rules, persons who have filed a Form 13D, 13F, or 13G stating their beneficial ownership can simply present a resolution; other economic owners must provide proof of ownership, provided by the record owner.232 Hedging does not affect the right to present a proposal, but would likely need to be disclosed under antifraud rules.233

Appraisal rights. The recent Transkaryotic case offers a road map for what can be termed "empty appraisal."234 An investor acquired shares in the secondary market, largely after the record date for the vote on a merger. Thus, it had not itself voted against (or not for) the merger; nor could it show how or if these precise shares had been voted. The shareholder argued that more shares than it held had either not been voted, or had been voted against the merger, and the

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229 Deephaven, 2005 WL 1713067. In Deephaven, a shareholder first borrowed shares in one account, then "sold" these shares to its own account with a different dealer. The Delaware court found that this created ownership in the second account and allowed a suit to proceed.
231 DEL. CODE ANN. tit. 8, § 211 (2001).
particular shares it held therefore might meet the statutory requirement of not having been voted for the merger. The Delaware Chancery Court found that this was a sufficient basis for exercising appraisal rights. We focus here not on the merits of the decision, but on a decoupling strategy that it makes possible.

Under Transkaryotic, a hedge fund can seek appraisal even if it held neither economic nor voting ownership on the record date. It also need not hold net economic ownership when it seeks appraisal—nothing in the Transkaryotic decision suggests that hedging one’s share ownership would result in the loss of appraisal rights. The hedge fund in Transkaryotic was a net economic owner, just not on the record date. But this need not always be the case. Thus, the right to seek appraisal potentially can be doubly empty—empty of the voting rights which were heretofore required to be held and exercised against or not for the deal, and potentially empty of economic ownership as well. The court recognized that gaming opportunities were possible, but felt that a remedy had to come from the legislature.

Unbundling economic ownership. Decoupling is also possible for the components of economic ownership. For example, strategies have been developed to use equity derivatives to avoid the withholding tax on dividends and, for tax-exempt entities, unrelated business income tax. Moreover, just as there are record date capture strategies to obtain voting rights, there are similar capture strategies, based on owning shares on dividend record dates, to obtain dividends. These strategies are attractive because of tax quirks in particular countries.

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236 The investor held shares through a record owner, and thus ultimately through Cede & Co., which is the first-tier record holder for most banks and brokers. The court limited the number of appraisable shares to the number held of record by Cede & Co. which were voted against the merger or not voted. This is a loose limit because Cede & Co. holds of record a large fraction of the shares in most public companies, and a significant percentage of these will go unvoted in a typical merger.
Preemptive rights can be decoupled as well; they can be acquired by borrowing shares, without economic ownership.\(^ {240} \)

In our view, investors' creativity in acquiring various rights—to sue, inspect books, obtain appraisal, or exercise preemptive rights—without economic ownership, if it becomes more than occasional, will call for a legislative or judicial response. At a minimum, we believe that courts should require disclosure of coupled and related non-host assets which affect economic interest in corporate and securities lawsuits. Perhaps too, the courts should look skeptically on exercise of rights without meaningful economic ownership, especially efforts to exercise rights with negative net economic interest.

2. Unbundling Shareholder Obligations

We turn next from rights to obligations. In addition to ownership disclosure, voting ownership conveys additional obligations, which can be sidestepped by acquiring economic-only ownership. First, anyone who crosses 10% voting ownership becomes subject to short swing profit forfeiture under Exchange Act section 16(b). This outcome can be avoided by holding a voting stake of less than 10%, regardless of one's total economic ownership.

Second, the Hart-Scott-Rodino Antitrust Improvements Act (Hart-Scott-Rodino Act) requires an investor which intends to purchase a sizeable stake in another company to obtain advance clearance from the U.S. antitrust authorities (Federal Trade Commission and Department of Justice).\(^ {241} \) An exemption lets institutional investors who have no control intent buy up to 10% of a company's shares, regardless of dollar amount.\(^ {242} \) However, the Hart-Scott-Rodino Act is triggered only by acquiring "voting securities";\(^ {243} \) cash-settled derivatives arguably do not count. This may let an acquirer first obtain economic-only ownership, then seek antitrust clearance, then morph its economic ownership into voting ownership as well.

Third, some state antitakeover statutes impose obligations or create disabilities (such as loss of voting rights or inability to complete a


\(^ {242} \) 16 C.F.R. § 802.9 (2007); see also Malcomb Pfunder, Shareholder Activism and the Hart-Scott-Rodino Act Exemption for Acquisitions of Voting Securities Solely for the Purposes of Investment, ANTITRUST, Summer 2006, at 74.

merger) if a shareholder crosses a specified ownership level.\footnote{244} In Indiana, for instance, when any person acquires either share ownership or "the power to direct the exercise of voting power" beyond a certain threshold, the shares generally lose voting rights unless the other shareholders vote to restore them.\footnote{245} In Delaware, an acquirer who crosses 15% ownership without the consent of the target board is generally barred from completing a merger with the target for three years.\footnote{246} While there are no cases on point, it seems unlikely that cash-settled equity derivatives would count toward the threshold. However, given the similar voting rights-based concept underlying the Schedule 13D trigger, we suspect that most practitioners would assume that the matched shares would generally not need to be included.

Fourth, standard poison pills are triggered by owning more than a specified percentage of the target’s shares. The definition of ownership used in most pills is borrowed from Exchange Act section 13(d), and does not capture cash-settled derivatives. To be sure, pill documents could be amended to include economic-only ownership, if companies saw the need to do so.

A fifth avoidable obligation arises in countries with "mandatory bid" rules, under which a shareholder who crosses a threshold for near-controlling ownership, often 30% or 33%, must offer to buy all remaining shares at the price paid to acquire its stake. But the threshold is measured in terms of enforceable voting rights—the morphable rights that often accompany economic ownership do not count. Examples in Table 1 of the use of economic-only ownership to avoid making a bid for all other shares include Fiat (Italy), SAI-Fondiaria (Italy), and John Fairfax Holdings (Australia).

Shareholders may have additional obligations in particular countries, which can be avoided through decoupling. In Korea, for example, the controlling shareholders of Hyundai Elevator wanted to hold enough shares in Hyundai Merchant Marine (Marine) to block a takeover bid for Marine by Hyundai Heavy Industries (controlled by a separate branch of the Hyundai group’s founding family). If it acquired more shares directly, it risked being considered a "holding company" under Korean law, with various adverse consequences.\footnote{247}

\footnote{244} For discussion of these laws, see STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 12.12 (2002).
\footnote{246} DEL. CODE ANN. tit. 8, § 203 (2001).
\footnote{247} This discussion is based on a series of reports by the Korean Center for Good Corporate Governance: Hyundai Elevator Again Enters into a Complicated Derivative Deal,
Instead of purchasing Marine shares directly, Elevator arranged for outside investors—Cape Fortune in 2004 and Nexgen Capital (a subsidiary of French bank IXIS) in 2006—to hold the shares, while using equity swaps and other contracts to protect the investors against loss, keep 80% of any gain, ensure that the investors voted as directed, and keep the right to acquire the shares when the contract period expired. The parking in this case was “hard,” because there were explicit contracts on economic return, voting, and disposal of the shares. The Korean Fair Trade Commission held in 2007 that Elevator’s strategy was indeed outside the Holding Company Act. Korean observers have speculated that other firms can use similar strategies to avoid the holding company regulations.248

Similarly, in the United States, soft parking potentially provides a way for a firm to avoid being considered to be an “investment company” under the Investment Company Act of 1940.249 An entity can become an “inadvertent” investment company if, among other things, it “owns . . . investment securities having a value exceeding [40%] of the value of such issuer’s total assets.”250 “Investment securities” include common shares in another company, but might well not include equity swaps or other derivatives.251

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Sometimes, the obligation to be avoided arises under contract. In 2007, Russia's Alfa Group, which owned stakes in two competing Ukrainian mobile telephone companies, faced an arbitration award requiring it to cut its indirect ownership in one of them, Kyivstar, to below 5%. It complied, or claimed to, by selling half of its stake to a Kazakh company, but retaining the right to repurchase the shares.\footnote{Alfa owned part of a Turkish cell phone company, Turkcell, which owned part of Kyivstar. After the arbitration decision, Alfa sold half of its stake in Turkcell. See Timofei Dzyadko, \textit{Sold to Hold}, VEDOMOSTI, Dec. 4, 2007 [Томофей Дзядко, Продали подержать, Ведомости], available at http://www.vedomosti.ru/newspaper/article.shtml?2007/12/04/137331; \textit{Number Portability To Stay, Says Court}, TURKISH DAILY NEWS, Dec. 5, 2007, available at http://www.turkishdailynews.com.tr/article.php?enewsid=90435.}

\textbf{B. Debt Decoupling and Empty Crediting}

Our analytical framework for equity decoupling, including many of its functional elements and terminology, can be extended to debt contracts. We discuss here some forms of debt decoupling and sketch some of their implications. Full treatment is beyond the scope of this Article. We offer a fuller treatment elsewhere.\footnote{See Hu & Black, \textit{Debt, Equity, and Hybrid Decoupling} (2008), supra note 4.}

Just as the conventional understanding of share ownership assumes the bundling of a standard set of rights and obligations, so too a traditional conception of debt ownership includes a standard package of economic rights (principally principal and interest payments), control rights, default rights, and other rights and obligations under contractual covenants, federal bankruptcy law, and, to a limited extent, state corporate law. Just as shareholders can easily reduce or eliminate their economic exposure by holding equity derivatives and other coupled assets, creditors can often reduce or eliminate their economic exposure through credit derivatives and other coupled assets. Creditors, like shareholders, can hedge in a number of ways. Just as shareholders can be empty voters, so too we can have "empty creditors." And so on.

One simple way for a creditor to hedge involves a credit default swap. The holder of the long side of a credit default swap accepts default risk from the short side. A creditor can thus hedge default risk by holding both risky debt and an appropriate short credit default swap position, much as a shareholder can hedge equity risk by holding both shares and the short side of an equity swap. A creditor can also hedge through other credit derivatives (e.g., a credit spread option...
whose payoff depends on the spread between the yield on a particular bond and a reference yield) or through strategies involving the company's shares, such as buying put options on the shares, or taking the short side of an equity swap.

Another general strategy for debt decoupling arises from repackaging of debt. A “loan participation” offers a simple example: a lead bank lends money to a corporation, but then transfers some, most, or even all of its economic return to other lenders. Often, the lead bank agrees to exercise its rights under the loan agreement to declare or waive defaults, amend covenants, and so on, as instructed by the buyers of the loan participations, in proportion to dollar amount owned. But some loan participation contracts leave these control rights with the lead bank. If so, the lead bank will have greater control rights than economic exposure. Decoupling is more common if the loans or other debt obligations are securitized into a collateralized loan obligations (CLOs) or collateralized debt obligations (CDOs). A trustee holds the formal rights as to the portfolio of debt. The terms of the CLO or CDO may or may not give the buyers of the CLO or CDO tranches rights to instruct the trustee on how to act. The interests of holders of different tranches can also differ widely. To complicate matters further, loan participants or CLO or CDO holders may be fully or partly hedged, or have other interests in the company's equity or debt.

The current housing finance crisis highlights some of the issues arising from debt decoupling. In the past, homeowners facing financial difficulty could try to negotiate directly with lenders for waivers and loan modifications. This is harder today. Many home mortgage loans are resold by the initial lender, securitized, or both. If a loan has been securitized, the effective holder of the lender's contractual rights—the servicing agent for the loan that deals with the homeowner—may have limited authority to make accommodations—or too

254 For a loan participation example involving decoupling of economic interest from control rights, see AutoStyle Plastics, Inc. v. MascoTech, Inc. (In re AutoStyle Plastics, Inc.), 269 F.3d 726, 736-37 (6th Cir. 2001).

255 Repackaging can also result in conflicts of interest. For example, CDO repackagers sometimes retain part of the securities they create. Citibank retained $43 billion in highly rated, senior tranches (only to later take a $10 billion write-off). Cracks in the Edifice, ECONOMIST, Nov. 10, 2007, at 89. If Citibank retained control rights for the underlying debt, it might face a conflict between actions that would benefit its own position and actions that would benefit more junior tranches.
little economic ownership to want to do so. The economic interest will often be spread among a wide range of investors, potentially around the world. Even if these investors had congruent interests—and often they do not because of the way the underlying obligations were divided into tranches—the transaction costs simply to find them would be prohibitive. Sometimes it can be unclear who holds the right to foreclose.

Beyond its implications for particular borrowers and creditors, debt decoupling may affect the stability of the world financial system. A potential benefit of decoupling is improved risk spreading, and thus reduced concentration of default risk on a limited number of financial institutions. On the other hand, the resting place of risk becomes uncertain. Market participants often want to deal only with reliably solvent counterparties. When a new source of risk emerges, if the holders of that risk cannot be readily identified, illiquidity can spread, and compound the losses from the initial risk event.

An additional concern is that, when debt is repackaged and resold, it becomes harder to modify the initial terms of the debt contract even when it would be efficient for both sides to do so. For any one loan, this is an efficiency loss and no more, to be weighed against the risk-spreading and other benefits of securitization and other forms of decoupling. But for a zillion loans, the inflexibility of the relationships among creditors and debtors creates systemic risk.

In the rest of this section, we focus more narrowly on corporate debt and on hedging through credit default swaps and discuss some implications of this form of debt decoupling. A creditor who has partly or fully hedged through a credit default swap nevertheless re-

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257 See, e.g., In re Foreclosure Cases, Nos. 3:07CV043, 07CV085, 07CV138, 07CV237, 07CV240, 07CV246, 07CV257, 07CV286, 07CV304, 07CV312, 07CV317, 07CV343, 07CV353, 07CV360, 07CV386, 07CV389, 07CV390, and 07CV433, 2007 WL 4056586 (N.D. Ohio Nov. 15, 2007); In re Foreclosure Cases, Nos. 1:07CV2282, 07CV2532, 07CV2560, 07CV2602, 07CV2631, 07CV2638, 07CV2681, 07CV2695, 07CV2920, 07CV2930, 07CV2949, 07CV2950, 07CV3000, and 07CV3029, 2007 WL 3232430 (N.D. Ohio Oct. 31, 2007) (rejecting foreclosure claims); cf. Gretchen Morgenson, Foreclosures Hit a Snag for Lenders, N.Y. TIMES, Nov. 15, 2007, at C1 (noting that lawyers for troubled homeowners may use this opinion to resist foreclosures on other loans).

258 In this Article, we leave aside several other ways in which debt decoupling may affect systemic risk, such as the impact of such decoupling on the initial credit decision and the impact of informational asymmetries with respect to the risk/return characteristics of the many complex securities that are often created.
DECOUPLING II

2008]

contains full contractual rights under the loan agreement or bond indenture, and full voting rights in bankruptcy. In contrast, the holder of the long side of the credit default swap bears default risk, but has no control rights. Control rights have been decoupled from economic rights. By analogy to empty voters, we can call a creditor which has hedged its economic risk an "empty creditor."

Just as equity investors can have negative economic ownership, and hence incentives to vote against the interests of other shareholders, so too can creditors. Suppose, for example, that a hedge fund, bank, or other investor holds $200 million of a company's bonds, but is also long a $500 million notional amount in credit default swaps on this debt. The investor has negative net economic ownership, and thus has an incentive to act to cause the company to fail—for example, to oppose an out-of-court restructuring—because it will profit more from its swap position than it will lose from its bonds. Within bankruptcy, the investor has an incentive to vote in ways that will reduce the value of the debt class it holds. Here too, there is a parallel with equity investors, who can potentially hold shares yet have negative net economic ownership.

The complexity of multiple classes of both equity and debt offers many possibilities for negative economic ownership. Instead of being long credit default swaps, our example investor could be long debt and short shares. It would then want to recover on its debt position but want to see little or no value left over for equity holders, so as to profit from its short position. Or, an investor could be long one class of the company's debt, and short another. It could be long both shares and debt, and seek to use its debt position primarily to generate a gain on its share position. And so on.

There is also an analogy to a shareholder's economic interest being affected by its positions in other companies—which we call related non-host assets. A creditor could hold long or short positions in the shares or debt of the company's competitors, giving rise to complex incentives with regard to this company's value.

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259 Apart from Hu, Shareholder and Creditor Decoupling (2007), supra note 3, and Hu & Westbrook, Shareholder and Creditor Interests (2007), supra note 3, the only academic discussions we are aware of that consider the possibility of empty crediting and negative creditor economic ownership are short discussions in Frank Partnoy & David A. Skeel, Jr., The Promise and Perils of Credit Derivatives, 75 U. CIN. L. REV. 1019, 1034-35 (2007), and an early stage working paper, Douglas Baird & Robert Rasmussen, Anti-Bankruptcy (Working Paper, Dec. 2007) (on file with authors).
Empty crediting can also affect creditor actions under the Bankruptcy Code. Suppose a creditor is fully hedged, with zero economic interest. The Code assumes that creditors will act to further their apparent economic interest, and will favor a bankruptcy filing only if they expect to receive more in bankruptcy than in an out-of-court restructuring. However, an empty creditor may prefer to force the company into bankruptcy, rather than agree to a restructuring, because the bankruptcy filing will trigger a contractual payoff on its swap position.

One important case in which "empty crediting" is rumored to be common involves investing in the debt of financially troubled companies. When a firm gets into financial distress, specialized "distressed debt" or "vulture" investors often accumulate large stakes in a debt class that are likely to be pivotal in the expected restructuring. For example, they may acquire a "blocking stake"—a position, typically one-third of a pivotal debt class, which may let the holder block adoption of a reorganization plan favored by other creditors, which ordinarily requires a two-thirds vote of creditors (though the judge can still approve a plan which does not receive this level of support). Unless hedged, these large positions convey large exposure to default risk. It is widely believed that distressed debt investors often hedge some of this risk, thus acquiring a large voting block without corresponding economic exposure.

These possibilities raise obvious questions: How common is partly or fully empty crediting? How often do creditors have negative economic ownership? We simply don’t know. Empty crediting occasionally comes to light in news stories. Bankruptcy practitioners worry about it. But there is no general requirement to disclose hedges, either in or out of bankruptcy.

Bankruptcy Rule 2019(a) requires disclosures by creditors who serve on ad hoc creditor committees of direct holdings of the company’s debt and equity. But it is unclear whether this rule requires

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262 FED. R. BANKR. P. 2019(a) ("[E]very entity or committee representing more than one creditor or equity security holder . . . shall file a verified statement [including] . . . the amounts of claims or interests owned by . . . the members of the committee . . . , the times when acquired, the amounts paid therefor, and any sales or other
disclosure of hedges, such as credit default swaps, which involve holding coupled assets rather than the company’s own securities. One recent bankruptcy court decision requires disclosure of at least some coupled assets; another does not. In any case, creditors can avoid this rule in a number of ways, including not serving on ad hoc committees and, oddly, gaining membership on an official creditor committee; official committees are exempt from Rule 2019.

For the extreme case of creditor negative economic ownership, one sign of smoke, which might signal an underlying fire, is the recent tendency for credit default swap form contracts to require the long swap holder, if it is also a creditor, to act in the interests of other creditors. This suggests concern that the long swap holder might not otherwise do so. But how the swap counterparty can enforce this obligation, without disclosure either of hedges or of how the long swap holder has voted on a restructuring, is anyone’s guess.

We do know that the opportunity for large-scale, undisclosed creditor hedging is present. Over the last decade, the credit default swap market has exploded. The notional amount of swaps outstanding often exceeds the amount of actual debt, sometimes manyfold. We have also heard from bankruptcy judges that they sometimes see odd behavior in their courtrooms, which “empty crediting” might help to explain. For example, one bankruptcy judge described a recent case wherein a junior creditor complained of too high a valuation being assigned to the bankruptcy estate, for reasons the creditor did not offer to the judge. One possible explanation is that the junior

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264 See Evan D. Flaschen & Kurt A. Mayr, Bankruptcy Rule 2019 and the Unwarranted Attack on Hedge Funds, AM. BANKR. INST. J., Sept. 2007, at 16, 16 (arguing that there is no policy reason to require disclosure for ad hoc committees, but not official committees). In theory, a sophisticated bankruptcy trustee could condition appointment of a creditor to an official committee on disclosure of coupled assets.

265 See Gillian Tett & Paul J. Davies, Unbound: How a Market Storm Has Seen Derivatives Eclipse Corporate Bonds, FIN. TIMES, Aug. 8, 2007, at 11 (explaining that the market for credit default swaps is now ten times larger than the dollar amount of underlying bonds); Richard Beales, Uncertain Road Ahead for Delphi, FIN. TIMES (London), Nov. 8, 2005, at 45 (describing the bankruptcy of Delphi, which had $2 billion of outstanding bonds, but ten times that amount in outstanding credit derivatives).
creditor had negative economic ownership of this debt class—or perhaps of the company's shares.

Corporate debt decoupling is also possible. Most bond indentures allow a company to hold and vote its own bonds. Even if an indenture does not allow the company to vote its own bonds, soft and hard parking offer ways to influence a vote on a restructuring proposal, in or out of bankruptcy.

There are parallels to equity decoupling with respect to disclosure as well. On the equity side, there is some disclosure of hedging and thus of economic ownership. On the credit side, there is usually none. "Hidden creditors" can exist as well—for example, investors who have taken the short side of credit default swaps. The extent to which this economic-only debt ownership is likely to be morphable, if the investor decides it wants covenant rights or voting rights in bankruptcy, we do not know, but the possibility surely exists.

Just as equity decoupling can potentially undermine standard assumptions that underlie the equity side of corporate governance (call this "equity governance"), so too on the debt side (call this "debt governance"). Both loan contracts and the Bankruptcy Code are premised on the assumption that creditors are averse to downside risk, but otherwise have an economic interest in the company's success and will behave accordingly. Voting in bankruptcy, in proportion to principal amount of debt held, rests on the same logic as a one-share-one-vote regime on the equity side—that control rights should be held by those with an incentive to increase the value of the firm, or at least the value of the asset class that is held. Large-scale, hidden debt decoupling weakens our ability to rely on these assumptions. Empty crediting implicates other core aspects of the bankruptcy process, including which creditors should serve on official or ad hoc creditor committees, whether the court should approve paying an ad hoc creditors committee's legal fees, and the weight a court should give to the views of particular creditors.

All this pushes in several directions. The first and most direct implication involves disclosure. We believe that disclosure of coupled assets should become a routine part of bankruptcy proceedings, perhaps with an exception for de minimis hedges or general hedges tied to an asset class, rather than a particular company's debt. Put differently, fully or partly empty creditors should disclose their "hidden non-

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266 See Hu & Black, Decoupling I (Law Review Version) (2006), supra note 1; supra Part IV.B.
interest": their lack of economic exposure to the company. Specifying
details of such a disclosure regime is beyond the scope of this article.

A more complex disclosure area involves knowing who holds eco-
nomic exposure to the company. This "hidden debt ownership" cor-
responds roughly to "hidden ownership" in the equity decoupling
context. Here we have, as yet, no firm recommendations to offer.

Beyond disclosure, debt contracts may need to adjust to the new
world of hedged interests, voting rights in bankruptcy may need to be
based on net economic ownership instead of gross ownership of debt,
and the extra complexities in devising sensible voting rules may pro-
vide support for proposals to rely more on auctions. Where auctions
are not available, proposals should rely less on creditor voting and
more on judicial discretion. Workout and reorganization procedures
will need to reflect a more complex world, in which we can no longer
assume that creditors want a higher recovery for their own class and,
inter-creditor conflicts aside, want a higher overall company value.

C. The Reemergence of Street Sweep Takeover Bids

For a brief time in the mid-1980s, a new form of takeover bid,
known as a street sweep, threatened to undermine U.S. takeover regu-
lation. A bidder would launch a tender offer, shares would move to
arbitrageurs, and then the bidder would drop the bid and rapidly buy
a large block of shares from the arbitrageurs in the market. Once this
technique had been tried a few times, the bidder didn't need to go
out and seek shares at all—the arbitrageurs would come to it and offer
their shares.

The culmination of the street sweep came in 1986, where Cam-
peau dropped its tender offer for Federated Stores at 8:30 a.m., and by
9:00 a.m. the Jefferies investment bank had contacted the major arbi-
trageurs, put together a 48% block of shares in Federated, negotiated
the price, and sold the block to Campeau, thus giving Campeau ma-
ajority ownership of Federated. Takeover battle over. 267

Bills were introduced in Congress to block street sweeps, and the
SEC introduced its own proposed anti-sweep rule. 268 Before either
body acted, street sweeps faded away, killed by a combination of poi-

267 For a discussion of this and other street sweeps, see Dale A. Oesterle, The Rise
and Fall of Street Sweep Takeovers, 1989 DUKE L.J. 202, 205-12.
268 See Acquisitions of Substantial Amounts of Securities and Related Activities Un-
taken During and Following a Tender Offer for Those Securities, Exchange Act Re-
son pills, state antitakeover laws, and the need for antitrust approval under the Hart-Scott-Rodino Act before a major acquisition.\textsuperscript{269} Yet, not all states have antitakeover rules that block sweeps, not all firms have poison pills in place, and antitrust approval can potentially be received before a bid is launched. Moreover, while the known sweeps relied on first making and then terminating a tender offer, it was scarcely obvious then, and is even less likely today, that this is necessary—a bidder can announce its plans to make a takeover bid, or even privately so advise some major shareholders, and wait for an offer to sell a block of shares to arrive.

Decoupling makes the street sweep strategy easier still. A bidder can acquire, cross the 5% threshold for 13D disclosure, and then, during the ten-day window before the 13D must be filed, buy up to 9.9% of a target’s shares (stopping short of the 10% level that would trigger short-swing profit forfeiture under Exchange Act section 16) and then use decoupling strategies to jump to a much higher level, perhaps to effective control. A bidder can borrow a block of shares while hedging, and then later release the hedge. Or it can acquire a large long equity swap position, and then unwind the swap to obtain shares. The key to both of these strategies is that they rely only on borrowing and a private transaction between a dealer or dealers and the bidder; they do not require market purchases and hence do not directly alert market participants or move market prices. Based on the facts available to us, the confidential case noted in Table 1 involves this fact pattern; it escaped publicity because the target was small.

If a bidder combines hedged purchases, with little or no market impact, with purchases from hedge funds, who often invest in parallel (the unkind term is “wolf pack”),\textsuperscript{270} the first public announcement of Bidder’s interest could be that Bidder has economic ownership, and possibly voting ownership, of a majority of Target’s shares. Several of the European takeover examples in Table 1 involve sudden emergence of a bidder with close to effective control of the target, including Scor-Converium, Vekselberg group-Sulzer, and Victory-Saurer. A variant on this theme is Laxey-Implenia, where Laxey acquired a 23% stake, which market participants understand is for sale at the right price to a takeover bidder. That bidder could potentially acquire 20-

30%, then jump to a control position by buying Laxey’s stake, all before any public disclosure.

Exchange Act section 16(b) does not block these strategies. It applies only once a shareholder already has 10% voting ownership, and thus it does not apply to shares acquired in a transaction in which a shareholder jumps from just under 10% to way over it. Nor does it reach shareholders who hold a 9.9% voting stake and the rest through long equity swaps.

A firm with a poison pill in place is still partly protected, and the pill could be amended to provide reasonably complete protection. Yet we scarcely want defense against a sneak takeover attack to require that every public company have a pill in place. The need for antitrust approval before turning economic ownership into voting ownership is a further obstacle to a street sweep. Still, the potential remains.

The right regulatory response is not obvious, and is beyond the scope of this Article. We observe here only that street sweeps are back today in Europe, and could appear tomorrow in the United States.

CONCLUSION

The concept that shareholders hold economic, voting, and other rights as well as disclosure and other obligations as an integrated whole is central to legal, regulatory, and economic understandings of the public corporation. This presumed coupling ensures that shareholders have an incentive to exercise voting rights to increase share value. The primary shareholder voting, corporate control market, disclosure, and other legal and market oversight mechanisms on which we rely to regulate public firms and their shareholders, and to constrain and incentivize managers to act in the interests of shareholder-owners, presume this coupling.

A similar assumption underlies the contractual and regulatory treatment of creditors. This coupling ensures that creditors have an incentive to exercise their contractual and bankruptcy rights well, which reduces the expected costs of financial distress. The presumed coupling of these rights and obligations pervades contracting practice, the Uniform Commercial Code, and the Bankruptcy Code.

Yet on both the equity and the debt side, these couplings are increasingly optional. On the equity side, shareholders can now readily decouple economic from voting rights, resulting in such patterns as empty voting, hidden ownership, morphable ownership, and empty appraisal. Corporations as well as shareholders can play the decoup-
ling game. On the debt side too, the unbundling of rights and disclosure obligations poses new and important challenges, both for individual creditors and debtors and perhaps for the financial system as a whole.

In this Article, we have concentrated on equity decoupling, and do so for the balance of the Conclusion. In Decoupling I, we examined the decoupling by shareholders of voting rights from economic ownership, and the associated potential for empty voting and hidden (morphable) ownership. In this Article, we treat these as specific examples of a broader concept of equity decoupling. We show how other standard shareholder rights and obligations can be delinked as well and offer illustrative examples.

We extend the concept of equity decoupling to decoupling by the corporation itself. A corporation cannot vote its own shares, but it can often do so in practice by “soft parking” shares in the friendly hands of derivatives dealers or other third parties.

We also provide evidence that equity decoupling has become an important worldwide phenomenon. We offer dramatic new examples, involving sneak decoupling-based takeover attacks on major firms, where a raider acquires a controlling or near-controlling stake prior to any public disclosure. In Switzerland, a series of these takeovers led to public outcry and a regulatory response. We can expect a similar outcry here if—perhaps when—similar examples emerge. It is appropriate to regulate now, because waiting for a crisis could lead to overreaction. We expand our prior integrated ownership disclosure proposal to cover corporate decoupling and better address share lending, and discuss recent U.K. evidence suggesting that our disclosure proposal is likely to yield valuable information without imposing large burdens on investors.

We also present a number of specific proposals that go beyond disclosure and respond to empty voting. These include providing constrained corporate power to limit the voting rights of empty voters, reconfiguring the relationships among annual meeting dates and voting and record dates, and encouraging institutional investors to recall and vote lent shares.

Finally, we discuss several implications and extensions of our analytical framework. We extend the concept of equity decoupling to include a full set of share-related rights and obligations. We extend the concept of decoupling to include debt decoupling. And we discuss how decoupling can contribute to the return of “street sweep” takeovers.
U.S. observers who continue to see equity decoupling as a curiosity of no current urgency would do well to look abroad. They also need to appreciate that a decade ago no one thought that debt decoupling raised serious public policy concerns. The benefits of debt decoupling were clear, but some important costs were not. As the front-page events that unfolded in mid-2007 have now made clear, debt decoupling has affected world economies in complex and important ways. Equity decoupling may have the same potential. Regulators elsewhere are responding: indeed, some major hedge funds have now called for regulatory responses to address hidden ownership and empty voting.

The development of large-scale equity decoupling is still fairly new. Its extent is only partly known. Its benefits and costs are largely unknown. We have therefore offered measured, cost-sensitive responses. We offer a simple, low-cost proposal for integrated ownership disclosure. This proposal will not prevent empty voting, but will likely reduce its extent. Our principal substantive proposal is for constrained corporate self-help—corporations can amend their charters to address empty voting, while being constrained not to use this new power in ways that are likely to entrench insiders. If, once disclosure reforms are in place, the level of empty voting is low, many corporations may do nothing. If they do something, they are unlikely to do much harm to share values. We propose reforms to encourage institutions to vote shares rather than lend them on record dates, but would not force them to do so.

Equity decoupling has benefits, and quite possibly larger benefits than costs, if one takes into account the value of hedging and short selling, which both involve decoupling. But equity decoupling is occurring against the background of a corporate governance paradigm and legal rules which largely assume that shareholders have coupled rights and obligations. Innovation now allows the decomposition of what seemed elemental. The granularity of analysis and regulation must change accordingly. A new set of possibilities and risks is emerging. It is appropriate to take measured steps to address those risks.