

NOTE

NEGATIVE VOTING: WHY IT DESTROYS SHAREHOLDER VALUE AND A PROPOSAL TO PREVENT IT

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In mid-2004, Mylan Laboratories (“Mylan”) offered to buy King Pharmaceuticals (“King”) for approximately \$4 billion.¹ Perry Corporation (“Perry”)—a hedge fund run by former Goldman Sachs investment banker Richard C. Perry—owned shares of King at the time of the merger’s announcement.² After the announcement, Perry proceeded to add to its position,³ and, by September 30, 2004, had accumulated seven million shares of King.⁴ Like other King shareholders, Perry stood to make a healthy profit if the deal was completed.⁵

To ensure that Mylan shareholders would approve the merger, Perry got creative. It bought 26.6 million shares, or 9.9%, of Mylan, but arranged to sell those same shares a few weeks later at the same price it had paid.⁶ Since the vote on the merger was to be held after the share purchase but before the share sale, Perry acquired the right to vote those shares in favor of the merger.⁷ The genius in this arrangement was the fact that Perry had completely hedged its economic exposure to Mylan with the forward sale contract, while still retaining its ability to vote. Perry had essentially bought Mylan votes.

Certain Mylan shareholders were understandably upset.⁸ Why should a party with no economic interest in Mylan be able to determine the fate of the merger? Even more upsetting to Mylan shareholders, Perry’s position in King shares gave it negative economic exposure to Mylan’s share price—if the merger was called off, Mylan’s price would rise to its pre-merger-an-

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¹ Ianthe Jeanne Dugan, *Hedge Funds Draw Scrutiny over Merger Play*, WALL ST. J., Jan. 11, 2006, at C1.

² Perry Corp., Schedule 13D as to Mylan Laboratories, Inc. (Nov. 19, 2004).

³ *Id.*

⁴ Perry Corp., Form 13F (Nov. 12, 2004).

⁵ Mylan’s buyout offer priced King shares at a premium of approximately 60% to King’s last pre-announcement closing price. Leila Abboud & Dennis K. Berman, *Mylan to Buy King Pharmaceuticals*, WALL ST. J., July 26, 2004, at A3.

⁶ David Skeel, *Behind the Hedge*, LEGAL AFFAIRS, Nov.–Dec. 2005, at 28.

⁷ *Id.*

⁸ Carl Icahn was upset enough to file suit. *See* Complaint, High River Ltd. P’ship v. Mylan Labs, Inc., 353 F. Supp. 2d 487 (M.D. Pa. Dec. 10, 2004) (No. 04-2677).

nouncement level while King's price would drop back to earth; if the merger went through, King's price would rise to the level of the bid while Mylan's price would decline further.⁹ Perry's position in King shares thus gave it the financial incentive to vote its borrowed Mylan shares in favor of the merger, the outcome that would best decrease Mylan's stock price. Perry had thus orchestrated the nightmare of corporate governance—some of those in control of the corporation had financial incentives to drive it into the ground.

The Mylan-Perry fiasco is representative of a broader phenomenon: the widespread decoupling of voting rights and economic ownership that has been made possible by the development of robust stock loan and derivatives markets.¹⁰ Henry Hu and Bernard Black have dubbed this decoupling the “new vote buying,” and have separated it into two categories: (1) “empty voting,” which refers to the pattern of “hold[ing] more votes than economic ownership” and (2) “hidden (morphable) ownership,” which refers to the pattern of “hold[ing] more economic ownership than votes.”¹¹ They describe the latter situation as “morphable” because it often involves the de facto ability to acquire the missing votes if needed.¹² Perry's position in Mylan Laboratories is an example of an extreme form of empty voting that occurs when a shareholder possesses voting rights but has a negative net economic exposure to movements in share price. This subcategory of empty voting—which I will refer to as “negative voting”¹³—is the primary focus of this Note.

This article proceeds as follows. Part I argues that negative voting has the most potential for wealth destruction of all forms of new vote buying, and should be the main, if not the exclusive, focus of legal reform efforts. Part II describes how a fund can accomplish negative voting without running afoul of current U.S. securities laws. Part III describes three proposals for reform that have the potential to curtail negative voting, but argues that these options are overbroad. Part IV describes the author's proposal for reform. Part V concludes.

⁹ Warren Buffett has offered an explanation for why companies often undertake acquisitions that reduce their share price. He notes that while major acquisitions “usually reduce the wealth of the acquirer's shareholders,” they “are a bonanza for the shareholders of the acquiree; they increase the income and status of the acquirer's management; and they are a honey pot for the investment bankers and other professionals on both sides.” Letter from Warren E. Buffett, Chairman of the Board of Berkshire Hathaway, Inc., to the Shareholders of Berkshire Hathaway, Inc. (Mar. 7, 1995), available at <http://www.berkshirehathaway.com/letters/1994.html>.

¹⁰ See Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 844–45 (2006).

¹¹ *Id.* at 812.

¹² *Id.* An owner of a physically-settled equity swap position often enjoys this “morphable” ownership. The swap owner can often close out its position to obtain shares directly, or can successfully lobby its counterparty to vote the shares in a desired manner. *Id.* at 836–39.

¹³ I will refer to a party that engages in negative voting as a “negative voter.”

I. THE PROBLEM OF NEGATIVE VOTING

A. *One Share, One Vote*

Frank Easterbrook and Daniel Fischel have made the case for “one share, one vote” (and against permitting vote buying) by arguing that “needless agency cost[s]¹⁴ of management” would arise were disproportionate voting power permitted: “Those with disproportionate voting power will not receive shares of the residual gains or losses from new endeavors and arrangements commensurate with their control; as a result, they will not make optimal decisions.”¹⁵ Easterbrook and Fischel give the example of a shareholder who owns 20% of a firm’s shares but 100% of its votes.¹⁶ This shareholder, they explain, will not have sufficient incentive to invest effort in improving the firm because the shareholder will reap just one-fifth of the value of those improvements.¹⁷ Furthermore, the shareholder will “have incentive to consume excessive leisure and perquisites” because the majority of the cost of that behavior will be borne by other shareholders.¹⁸ Easterbrook and Fischel thus identify two inefficiencies that would result from permitting vote buying: (1) shareholders would invest too little in deciding how to vote and (2) shareholders would be able to more effectively extract private benefits at the expense of other shareholders.¹⁹

Of all the forms of Hu and Black’s “new vote buying,” negative voting has the most potential to create inefficiencies of the types that Easterbrook and Fischel identified. While empty voters with positive or zero net economic exposure to a stock (hereafter, “non-negative empty voters,” who will be said to engage in “non-negative empty voting”) might well invest sub-optimally in finding and voting for ways to improve the firm, negative voters have *zero* incentive to search for such improvements. Moreover, negative voters have much more incentive to extract private benefits from the firm than do non-negative empty voters. This is true because a negative voter profits both from the private benefit that it obtains—as any non-negative empty voter would—and from any reduction in share price that results from this extraction.

¹⁴ Broadly speaking, “agency costs” are those costs that arise when the interests of a principal and agent diverge. For a more detailed description of agency costs, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–09 (1976).

¹⁵ FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 73 (Harvard Univ. Press 1996) (1991).

¹⁶ *Id.* at 74.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ An example of the extraction of private benefits is the case of a manager who is also a shareholder and uses her voting clout to elect a close friend onto the board of directors. When that friend uses his influence to secure approval of the manager’s excessive pay package, she has extracted a private benefit from the firm.

A negative voter also causes greater inefficiency than does a shareholder that engages in hidden (morphable) ownership (hereafter, a “hidden owner”). A hidden owner with a 10% voting stake and a 30% economic stake in a firm has much less incentive to extract private benefits than a negative voter with a 10% voting stake and economic exposure of negative 10%. For each dollar extracted, a hidden owner will lose thirty cents due to its share ownership, while the negative voter will gain an additional ten cents indirectly (from the expected drop in share price). Furthermore, while a hidden owner’s investment in finding and voting for ways to improve the firm will depend on how effectively it can win the support of other shareholders by proxy solicitation, such investment—even if suboptimal with regard to the firm as a whole—is certainly preferable to a negative voter’s efforts to find ways to bankrupt the firm.

This application of Easterbrook and Fischel’s framework to the various forms of new vote buying examined by Hu and Black suggests that negative voting is the worst form of new vote buying.

B. *The Virtues of Vote Buying*

The analysis thus far has focused on the costs of deviations from “one share, one vote,” but what about the benefits of such deviations? Some shareholders lack the time, energy, and/or expertise to make voting a profitable endeavor.²⁰ Other shareholders are instead well-equipped to take an active role in the governance of the corporation.²¹ The new vote buying, like other deviations from “one share, one vote,” offers possible benefits by allowing those who are best equipped to vote to exercise disproportionate influence.²² Passive shareholders can sell their votes to activist shareholders, the theory goes, and each group will be better off from the transaction.

But this is only part of the story. While a sale of votes from one party to another is presumably wealth-enhancing for each party, this does not take into account third party shareholders²³ that would be harmed if the vote sale

²⁰ See Robert C. Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776, 779–81 (1979).

²¹ See Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1024–26 (2007) (detailing recent hedge fund activism); see also April Klein & Emanuel Zur, *Hedge Fund Activism* (N.Y.U. Law & Econ. Research Paper Series, Working Paper No. 06-41, 2006), <http://ssrn.com/abstract=913362> (reporting results from an empirical study that finds “hedge funds have engaged in successful and profitable activist campaigns against a large group of publicly-traded companies”).

²² See Richard Hasen, *Vote Buying*, 88 CAL. L. REV. 1323, 1349–54 (2000) (arguing that the justifications for banning political vote buying do not apply in the corporate context).

²³ In the context of a sale of votes from party A to party B in a given stock, the term “third party shareholders” will refer to all shareholders of that stock other than parties A and B. Because much of the “new vote buying” involves transactions that are different from traditional vote buying but accomplish the same effect—like the equity swap Perry entered into with Goldman Sachs—in those cases “third party shareholders” refers to those shareholders not engaged in the new vote buying transaction.

results in a lower share price. The real danger with vote buying—from an efficiency standpoint—is that the harm done to third party shareholders exceeds the benefit that accrues to the transacting parties. The key to ensuring efficient outcomes, then, is to restrict vote buying to instances in which third party shareholders are not harmed by the vote sale.

Delaware law restricts vote buying to precisely those circumstances. In the landmark case of *Schreiber v. Carney*,²⁴ the Delaware Chancery Court—rejecting a mandatory “one share, one vote” rule—held that vote buying is not per se illegal “unless the object or purpose is to defraud or in some way disenfranchise the other stockholders” and is “subject to a test for intrinsic fairness.”²⁵ In *Schreiber*, Jet Capital Corporation owned enough shares of Texas International Airlines stock to veto a proposed reorganization.²⁶ Jet Capital was against the reorganization because it would incur substantial tax liability if the plan were to go through.²⁷ Texas International bought Jet Capital’s approval in the vote by giving it a loan to cover its tax liability.²⁸ This loan agreement was approved by both a majority of all shareholders and a majority of shareholders other than Jet Capital and its officers and directors.²⁹ The court held that the agreement constituted vote buying, but that it was for the permissible purpose of “furthering the interest of all Texas International stockholders.”³⁰ The agreement passed the test for “intrinsic fairness” because it was ratified “by a majority of the independent stockholders, after a full disclosure of all germane facts with complete candor.”³¹ In short, the court found that the shareholders not party to the vote buying transaction were sufficiently protected by their voting rights.

Because the nature of the effect on third party shareholders is what separates beneficial vote buying arrangements from destructive ones, it makes sense to examine how the various forms of new vote buying impact share price. By definition, a negative voter has a financial incentive to bring about decreases in share price,³² while non-negative empty voters and hidden

²⁴ 447 A.2d 17 (Del. Ch. 1982).

²⁵ *Id.* at 25–26. Compare this approach with that of New York, which prohibits vote buying. See N.Y. BUS. CORP. LAW § 609(e) (McKinney 2003) (“A shareholder shall not sell his vote.”).

²⁶ *Schreiber*, 447 A.2d at 19.

²⁷ *Id.*

²⁸ *Id.* at 20.

²⁹ *Id.*

³⁰ *Id.* at 26.

³¹ *Id.*

³² Shaun Martin and Frank Partnoy call situations like this, in which shareholders with other portfolio positions have incentives to vote to the detriment of pure shareholders, “voting arbitrage.” Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 809–10 (2005). Martin and Partnoy list three examples of voting arbitrage: “(1) increasing volatility to the benefit of option holders but to the detriment of unencumbered shareholders; (2) undertaking projects with negative net present value; and (3) not undertaking projects with positive net present value.” *Id.* at 810. To this list, Martin should add a fourth item: decreasing volatility to the benefit of those short options but to the detriment of unencumbered shareholders. Martin and Partnoy use the adjective “unencumbered” to refer to those shareholders who

owners generally have positive economic exposure to stock moves.³³ Third party shareholders thus have much more to worry about from negative voters than from parties engaged in the other forms of the new vote buying. Furthermore, the model vote buying scenario described above—in which a passive shareholder sells votes to an activist shareholder and all are better off—clearly breaks down in the case of negative voting. With negative voting, control passes from a passive shareholder to a destructive shareholder, so it is highly unlikely that all will be better off. Additionally, if negative voting is involved, the fact that the passive shareholder consented to the transaction hardly shows that it stood to benefit. For if the passive shareholder were aware it was selling to a negative voter, it might well not have sold.

The analysis in this part strongly suggests that negative voting is more troubling than the other forms of the new vote buying: non-negative empty voting and hidden (morphable) ownership. While a case can be made that deviations from “one share, one vote” should be permitted if the interests of third party shareholders are sufficiently protected, negative voting clearly fails this test, as negative voters have the financial incentive to harm third party shareholders to the greatest degree possible.

The remainder of this part compares negative voting directly with hidden (morphable) ownership by examining what in practice has motivated shareholders to employ each of these techniques. This examination provides further support that negative voting is the most destructive of all forms of the new vote buying.

C. *Negative Voting Versus Hidden (Morphable) Ownership in Practice*

Perry’s maneuvering during the Mylan-King courtship might cause one to ask: why didn’t Perry use derivatives markets to get additional, direct negative economic exposure to Mylan’s share price?³⁴ Two possible explanations appear most probable. First, Perry already had negative exposure to Mylan share movements due to its large long position in King shares. Perhaps Perry was not confident—with good reason, it turns out³⁵—that its votes were enough to ensure the merger would go through, making it reluctant to increase its short exposure to Mylan. Second, Perry might have feared that it would face greater scrutiny from the SEC and potential liability from

are pure residual claimants, that is, shareholders who have neither loaned out their shares nor possess exposure to the stock outside of share ownership. *See id.* at 787.

³³ Robert Clark has argued that vote buying should be permitted if vote buyers are protecting an equity stake in the firm and if other shareholders are sufficiently protected. Clark argues that a vote buyer’s positive exposure to stock price movements is highly relevant to the question of whether a given instance of vote buying should be permitted. Clark, *supra* note 20, at 791, 806–07.

³⁴ For example, Perry could have bought puts or sold calls on Mylan stock so that it would have had even more negative exposure to Mylan’s share price.

³⁵ Mylan and King decided to terminate their merger agreement on February 27, 2005. *Mylan Abandons Pact to Purchase Drug Firm King*, WALL ST. J., Feb. 28, 2005, at B4.

Mylan shareholders if it established direct negative exposure to Mylan stock, rather than the indirect exposure it had from its King position.

One hedge fund, however, has gone where Perry refused to go—establishing a short position in another company's shares in order to profit directly from drops in share price due to the fund's voting activity. This occurred in Hong Kong in 2006, when Henderson Land attempted to take its subsidiary, Henderson Investment, private by buying out the shares it did not already own.³⁶ An unnamed hedge fund successfully voted its shares of Henderson Investment to block the buyout, and then sold short Henderson Investment stock to take advantage of the 17% drop in share price that occurred the next day due to the failure of the buyout attempt.³⁷ This hedge fund was able to block the deal because, due to an idiosyncrasy in Hong Kong law, only 2.5% of the outstanding shares were needed to block a buyout.³⁸ The Henderson debacle represents corporate governance at its worst—one party using share lending and stock shorting to privately benefit while causing others to incur massive losses. While this is a single instance,³⁹ the lesson to profit-seeking parties is clear: money can be made by sabotaging corporate events that would otherwise have increased shareholder value.⁴⁰

This discussion next examines concrete examples of hidden (morphable) ownership. Hu and Black give two motivations for employing hidden (morphable) ownership. One is to avoid disclosure rules; the other is to avoid mandatory bid rules.⁴¹ In the international arena, multiple cases of investors using hidden (morphable) ownership to circumvent disclosure rules have been reported.⁴² In one incident in New Zealand, Perry Corporation owned just under 5% of Rubicon shares but held an additional 11% of economic ownership via cash-settled equity swaps executed with Deutsche Bank and UBS Warburg.⁴³ Perry presumably did this to avoid New Zealand's large shareholder disclosure rules, which mandate disclosure of 5% ownership positions in public corporations.⁴⁴ When Perry wanted to vote its full

³⁶ Patricia Cheng, *Hedge Funds Find Loophole in H.K.*, INT'L HERALD TRIB., Feb. 16, 2006, at 18.

³⁷ *Id.*

³⁸ Hu & Black, *supra* note 10, at 834.

³⁹ Because negative voters can generally avoid disclosure requirements, *see infra* Part II, the full extent of negative voting is unknown. David Skeel suggests that negative voting might be a common occurrence: "Multiply Perry's behavior by the thousands of shareholder votes that occur every year at thousands of companies, and that's a lot of potentially lousy deals supported by major shareholders advancing narrow interests—and a lot of potential damage to the economy." Skeel, *supra* note 6, at 28–29.

⁴⁰ Concededly, it is the rare corporate event that can be derailed by the dissent of a mere 2.5% of the vote. But there are clearly shareholder votes that are won or lost by small margins. In those votes, even modest amounts of negative voting can translate into big losses for shareholders.

⁴¹ Hu & Black, *supra* note 10, at 839.

⁴² *See id.* at 836–37, 868–69 (discussing such use by Perry Corporation in New Zealand and Glencore International in Australia).

⁴³ *Id.* at 836.

⁴⁴ Securities Amendment Act 1988, §§ 2, 26 (N.Z.).

economic stake, it merely terminated the equity swaps and bought back shares from the dealers.⁴⁵ As for U.S. disclosure rules, Hu and Black report that “[p]ractitioners at law firms prominent in the OTC derivatives market apparently take the position that disclosure of cash-settled equity swap positions is normally not required.”⁴⁶

Many countries have mandatory bid rules that require a shareholder to offer to buy all shares it does not own if its ownership share exceeds a certain threshold.⁴⁷ In 2005, the Agnelli family used equity swaps to avoid the 30% share ownership threshold that triggers Italy’s mandatory bid rule.⁴⁸ Through shares of stock and equity swaps, the Agnellis owned an economic stake in Fiat that exceeded 30%, but, because their share position did not exceed 30% of all shares, they did not trigger the mandatory bid rule.⁴⁹

The extent of damage caused by these two examples of hidden (morphable) ownership is unclear. Hidden (morphable) ownership enabled Perry merely to conceal the extent of its economic stake in Rubicon. The Agnelli family used hidden (morphable) ownership to accumulate a large stake in Fiat without being forced to bid for all Fiat shares. Each of these hidden owners stood to profit if the company flourished. But while the wisdom of the rules that Perry and the Agnelli family sought to avoid is debatable,⁵⁰ the danger of giving voters the incentive to bankrupt a corporation is clear.

To summarize, this part examined how the effects of negative voting compare to the effects of the other two forms of new vote buying: non-negative empty voting and hidden (morphable) ownership. Part I.A argued that negative voting, of the three forms of new vote buying, is most likely to create inefficient agency costs of management and the inefficient extraction of private benefits from the firm. Part I.B suggested that vote buying could be beneficial if third party shareholders are sufficiently protected, but argued that negative voting behavior, of all forms of new vote buying, is most likely to damage third party shareholder interests. Finally, Part I.C argued that an examination of real world cases of negative voting and hidden (morphable) ownership indicates that negative voting is more clearly objectionable.

While non-negative empty voting and hidden (morphable) ownership are questionable practices, negative voting is the black sheep of the new vote buying family. The case for its ban is the strongest.

⁴⁵ See Hu & Black, *supra* note 10, at 836.

⁴⁶ *Id.* at 868 (citing publications by partners at Allen & Overy and Cleary, Gottlieb). “OTC” is shorthand for “over the counter,” and refers to trading activity that occurs outside of the stock and derivative exchanges.

⁴⁷ *Id.* at 839.

⁴⁸ *Id.* at 839–40.

⁴⁹ *Id.*

⁵⁰ See, e.g., Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *YALE L.J.* 2359, 2372–88 (1998) (arguing for the removal of mandatory disclosure requirements); Luca Enriques, *The Mandatory Bid Rule in the Takeover Directive: Harmonization Without Foundation?*, 1 *EUR. COMPANY FIN. L. REV.* 440, 441–42 (2004) (arguing that the European Commission’s mandatory bid proposal would create a “less efficient market for corporate control”).

II. NEGATIVE VOTING UNDER CURRENT REGULATIONS

This part explains how an entity⁵¹ can engage in negative voting without triggering disclosure under current U.S. securities regulations.

A. *The Basics of Negative Voting*

To accomplish negative voting, an entity must have (1) voting rights in a stock and (2) negative net economic exposure to movements in that stock's price. This discussion first describes how in practice a negative voter can establish each of these positions. It then discusses the relevant disclosure requirements.

There are two ways to obtain voting rights in a stock: by buying the stock or by borrowing the stock. Buying shares gives the purchaser both a voting stake in, and positive economic exposure to, the company; borrowing shares leaves the borrower with only a voting stake.⁵² Because buying shares creates undesirable (for a negative voter) positive economic exposure to the stock, a negative voter should prefer borrowing shares to buying shares, all else equal.

There are numerous methods for acquiring negative economic exposure to a stock. The most straightforward is selling borrowed shares, or "shorting" the stock. Derivatives markets provide numerous additional options, including buying puts, selling calls, selling "combos,"⁵³ selling single-stock futures, executing forward sale agreements (as Perry Corp. did for its Mylan position),⁵⁴ and executing equity swaps. While an investor who sells stock short will lose the ability to vote those shares, establishing short positions via derivatives markets generally does not reduce voting power.⁵⁵

⁵¹ Broad terminology is appropriate here because a diverse cast engages in the new vote buying, including hedge funds, banks, non-financial corporations, and high-net-worth individuals and families. See Hu & Black, *supra* note 10, at 848–49 (listing "the known or publicly rumored instances of new vote buying" in table form).

⁵² A stock purchase can be transformed into a mere stock loan by entering into a forward contract to sell an identical number of shares at a later date, as Perry did with its Mylan position. See *supra* text accompanying notes 6–7.

⁵³ Selling a "combo" is accomplished by selling a call and buying a put on the same underlying stock where the call and put have identical maturity and strike price. The economic position that results from selling a combo closely approximates the position that results from selling shares directly. See SHELDON NATENBERG, *OPTION VOLATILITY AND PRICING* 213–16 (McGraw-Hill 1994).

⁵⁴ See Skeel, *supra* note 6, at 28.

⁵⁵ In some cases, derivatives trades require posting of collateral: buying puts does not—because the buyer pays the premium up front and can only be a creditor upon maturity—while selling calls does. Parties can generally post cash collateral, but often post shares instead. To the extent that the posting of shares prevents those shares from being voted, a negative voter would favor use of cash collateral over share collateral.

B. Schedules 13D and 13G

In the United States, an entity that acquires more than 5% of a public company's shares must file a Schedule 13D with the SEC within ten days of crossing that threshold.⁵⁶ A borrower of over 5% of a company's shares would almost certainly be required to file a Schedule 13D.⁵⁷ This is true because disclosure is based on the magnitude of "beneficial ownership" under Rule 13d-3, and because the "beneficial owner" of a security is defined to include anyone who "directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) [v]oting power which includes the power to vote, or to direct the voting of, such security; and/or, (2) [i]nvestment power which includes the power to dispose, or to direct the disposition, of such security."⁵⁸

Certain types of investors can escape filing a Schedule 13D, and instead file a Schedule 13G, if they acquire shares "in the ordinary course of . . . business and not with the purpose nor with the effect of changing or influencing the control of the issuer."⁵⁹ Like Schedule 13D, Schedule 13G filing is triggered by "beneficial ownership" under Rule 13d-3, so borrowers of more than 5% of a publicly traded company's stock would need to file one of the two schedules. While Schedule 13D must be filed within 10 days of crossing the 5% threshold, a Schedule 13G "shall be filed within 45 days after the end of the calendar year" and is triggered by "the person's beneficial ownership as of the last day of the calendar year."⁶⁰ This difference in timing is of great importance, for if an entity that qualifies for filing a Schedule 13G (due to lack of control intent) reduces its position to below 5% before year-end, it does not need to report at all. This difference in filing requirements diminishes once an entity for which Schedule 13G is available acquires beneficial ownership of more than 10%. When that occurs, the entity must file a Schedule 13G "within 10 days after the end of the first month" in which the 10% threshold was crossed⁶¹—a less exacting timeline than that of Schedule 13D.

A negative voter can therefore acquire the voting rights of a 4.9% stake in a public company—by buying or borrowing shares—without triggering either Schedule 13D or Schedule 13G disclosure. In addition, a negative voter that acts "in the ordinary course of . . . business and not with the purpose nor with the effect of changing or influencing the control of the

⁵⁶ Exchange Act Rule 13d-1, 17 C.F.R. § 240.13d-1(a) (2007).

For a detailed analysis of the effect of securities regulations on new vote buying, see Hu & Black, *supra* note 10, at 864–75. Hu and Black do not focus specifically on the obstacles these regulations provide to parties engaging in negative voting.

⁵⁷ Hu and Black have a more moderate view on this point, reasoning that borrowing shares would only "likely count toward triggering disclosure." *Id.* at 868.

⁵⁸ Exchange Act Rule 13d-3, 17 C.F.R. § 240.13d-3(a) (2007).

⁵⁹ Exchange Act Rule 13d-1, 17 C.F.R. § 240.13d-1(b) (2007).

⁶⁰ *Id.*

⁶¹ *Id.*

issuer” can escape reporting altogether if it keeps its position—borrowed or bought—under the 10% threshold and exits its position by year-end.⁶² Voting stakes of 4.9% and 9.9% can have a substantial impact in company votes, in particular for votes under statutes that require simple majority voting (i.e., a majority of shares *voted* rather than a majority of all outstanding shares entitled to vote). As a result, negative voters can acquire significant voting clout without triggering Schedule 13D and Schedule 13G filing requirements.

Short positions, whether acquired through derivatives or direct short sales, trigger neither Schedule 13D nor Schedule 13G filing because they do not constitute “beneficial ownership.”⁶³ Yet it is worth noting that if an investor is required to file a Schedule 13D due to its position in an issuer’s securities, such filing requires disclosure of “any contracts, arrangements, understandings or relationships (legal or otherwise)” between the filer and any person “with respect to any securities of the issuer.”⁶⁴ Thus, in certain instances, short positions might need to be reported on Schedule 13D. Unlike Schedule 13D, Schedule 13G does not require disclosure of these other contracts and arrangements.⁶⁵

Two other securities regulations provide less significant obstacles to negative voting: the Form 13F and Section 16 disclosure requirements.

C. Form 13F Disclosures

Form 13F requires “institutional investment manager[s]” to provide quarterly disclosure of any positions in “section 13(f) securities” that have an aggregate month-end value in excess of \$100 million.⁶⁶ “[S]ection 13(f) securities” include only publicly traded securities⁶⁷—and not OTC structures—and the SEC has instructed that short positions do not need to be disclosed.⁶⁸ A lender of stock reports the stock as its own (assuming the value of the stock is over \$100 million), but the borrower does not need to

⁶² *Id.*

⁶³ Hu & Black, *supra* note 10, at 867.

⁶⁴ Schedule 13D, 17 C.F.R. § 240.13d-101 (2007). This requirement is found under “Item 6.”

⁶⁵ Schedule 13G, 17 C.F.R. § 241.13d-102 (2007).

⁶⁶ Exchange Act Rule 13f-1, 17 C.F.R. §240.13f-1(a) (2007). Exchange Act section 13(f)(5)(A) offers a broad definition of “institutional investment manager”: it “includes any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.” Securities Exchange Act, 15 U.S.C. § 78m (2006).

⁶⁷ 17 C.F.R. § 240.13f-1(c).

⁶⁸ FAQ About Form 13F, Question 41 (May 2005), <http://www.sec.gov/divisions/investment/13ffaq.htm> (“You should not include short positions on Form 13F. You also should not subtract your short position(s) in a security from your long position(s) in that same security; report only the long position.”).

report its borrowing.⁶⁹ The additional constraints this imposes on negative voting behavior are twofold: (1) if the negative voter wants to acquire votes by purchasing public shares, it must either hold less than \$100 million in stock value or be sure to reduce a larger position to below \$100 million at quarter-end⁷⁰ and (2) if the negative voter wants to establish negative economic exposure to the company via exchange-traded options, it must keep the value of those options under \$100 million at quarter-end.

Form 13F does little to constrain negative voting activity. Negative voters can obtain votes by borrowing—rather than buying—shares, and Form 13F does nothing to require the reporting of share lending transactions.⁷¹ In addition, even if negative voters choose to acquire votes by buying shares, they can still avoid Form 13F reporting by reducing the value of their stock position by quarter-end.

D. Section 16 Disclosures

Section 16 of the Exchange Act applies to “[e]very person who is directly or indirectly the beneficial owner of more than 10 percent of any class of [any non-exempt, registered security], or who is a director or officer of the issuer of such security.”⁷² Because negative voters are rarely, if ever, directors and officers of the firm they are seeking to bankrupt and because the 10% threshold, which triggers a requirement of disclosure within ten days,⁷³ is based on the definition of “beneficial ownership” from Section 13(d),⁷⁴ Section 16 adds little in the way of required disclosure for those engaged in negative voting. The little disclosure that it does add applies when Schedule 13G is available to a negative voter with beneficial ownership of the security that exceeds the 10% threshold. In that situation, Section 16 requires filing within ten days while Section 13(g) requires filing by the tenth day of the next month. However, negative voters who are not officers and directors of the issuer and who successfully evade all other disclosure requirements do not need to change their behavior to avoid Section 16 filing requirements.

⁶⁹ *Id.* at Question 42 (“You should report securities that you own and have loaned to a third party on your Form 13F. The third party that borrows these securities from you should not report them.”).

⁷⁰ To compare with the 5% threshold from the Schedule 13D and 13G reporting requirements, a shareholder will reach the \$100 million threshold sooner than the 5% threshold if the market cap of a company is over \$2 billion (and later if the market cap is below).

⁷¹ See Hu & Black, *supra* note 10, at 872.

⁷² Exchange Act § 16(a)(1), 15 U.S.C. § 78p(a)(1) (2006).

⁷³ Exchange Act § 16(a)(2)(B), 15 U.S.C. § 78p(a)(2)(B) (2006).

⁷⁴ Exchange Act Rule 16a-1(a)(1), 17 C.F.R. § 240.16a-1(a) (2006).

E. A Recipe for Negative Voting

This part concludes with a discussion of two methods by which an entity can engage in negative voting and escape the aforementioned disclosure requirements entirely.

First, assume the entity chooses to obtain voting power by purchasing shares. If this entity is acting in “the ordinary course of business” and without the purpose to, or the effect of, control, then Schedule 13G is available, and it can buy 9.9% of the company’s shares without reporting. If Schedule 13G is not available, the entity can buy 4.9% of the company without reporting. If the negative voter’s share position is worth more than \$100 million, the negative voter will need to pare its position down to \$100 million by quarter-end to avoid Form 13F filing.

To obtain negative economic exposure to the company, it would not make sense for the negative voter to sell shares, as those sales would erase its voting position. Instead, it can buy puts, sell calls, sell “combos,” enter into forward sale agreements, or gain negative exposure via equity swaps. The only practical limit on establishing this negative economic exposure is the \$100 million limit provided in Form 13F, which applies to exchange-traded options. This threshold, however, can be circumvented through the use of OTC derivatives trades or by reducing the magnitude of the exchange-traded options positions by quarter-end.

Under the second method of negative voting, the negative voter obtains voting power by borrowing shares. That investor can borrow 4.9% of the shares outstanding, sell that 4.9% stake, leaving a pure short position (and no voting power), and repeat this pattern. Once the entity has accumulated a sufficient negative position, it can borrow a final block of 4.9% (or 9.9% if Schedule 13G is available) that it will not sell. Again, the entity might need to adjust the size of the position at month-end to avoid Form 13F filing requirements. While this entity could use listed options or OTC derivatives markets to obtain negative exposure, a short selling strategy would be simple, effective, and disclosure-free. As in the previous example, there is no disclosure-based constraint on the magnitude of the negative economic exposure that can be obtained.⁷⁵

III. CURRENT PROPOSALS

While the preceding analysis demonstrates that current securities regulations allow investors much freedom to engage in negative voting, this part describes and criticizes various reform proposals that address this regulatory loophole. Each proposal attacks new vote buying from a different angle and

⁷⁵ There is a practical constraint on the amount of shares that a negative voter can borrow: cost. The share lending market is subject to supply and demand pressures, and the cost of borrowing stock begins to increase as supply dries up.

thus has its individual strengths and weaknesses. Yet these proposals all share the same general weakness: their approach is overbroad. They focus on preventing empty voting or both empty voting and hidden (morphable) ownership, rather than on preventing negative voting. But the effects of non-negative empty voting and hidden (morphable) ownership are ambiguous, and the precautionary principle urges against regulation of ambiguous phenomena. Furthermore, these proposals would impose costs on a variety of actors in the financial system that have nothing to do with negative voting behavior. As the discussion below illustrates, negative voting would be deterred by these proposals, but at great cost.

A. Large Scale Expansion of Disclosure Requirements

Hu and Black's answer to the problem of new vote buying is their "integrated ownership disclosure" proposal:

We propose simplifying the disclosure architecture by (1) moving toward common standards for triggering disclosure and for disclosing positions once disclosure is required; (2) providing a single set of rules for which ownership positions to disclose and how to disclose them; (3) requiring disclosure of all positions conveying voting or economic ownership, arising from shares or coupled assets; and (4) requiring symmetric disclosure of positive and negative economic ownership.⁷⁶

Their proposal combines a standardization of many of the existing reporting regimes (such as Sections 13(d), 13(f), 13(g), and 16) and an expansion of the types of arrangements and economic positions that must be reported.⁷⁷ Stock lending, which currently escapes reporting entirely,⁷⁸ would be covered under Sections 13(d), 13(f), 13(g), and 16 under the "integrated ownership disclosure" proposal.⁷⁹ Stock borrowing and derivatives positions would move from having the current minimal reporting requirements⁸⁰ to generally being covered when an equivalent amount of share ownership would have required reporting.⁸¹ Lastly, reporting on share lending and borrowing would be required "even if unaccompanied by economic ownership."⁸²

Although it is a move in the right direction, Hu and Black's proposal has two weaknesses: (1) it likely underestimates the cost of implementation and (2) it primarily targets hidden (morphable) ownership and does not suffi-

⁷⁶ Hu & Black, *supra* note 10, at 876.

⁷⁷ *Id.* at 875–86.

⁷⁸ *Id.* at 866.

⁷⁹ *Id.* at 881.

⁸⁰ *Id.* at 866.

⁸¹ *Id.* at 881.

⁸² *Id.* at 878.

ciently deter negative voting, the most damaging of all forms of new vote buying.

Hu and Black state that they “expect, but cannot prove, that overall disclosure costs would decline.”⁸³ They write that “additional compliance costs should be limited” because their proposal “builds on existing disclosure technology,” “requires only information readily accessible to investors,” and “simply extends existing disclosure practices for insiders and mutual funds to a broader class of reporting persons.”⁸⁴ They expect, however, that those costs will be more than offset by cost savings from having a simplified disclosure regime.

While an accurate cost comparison of the current regime and Hu and Black’s regime is next to impossible, there are reasons to expect that the costs of their proposed changes would be significant. Both the share lending market and the derivatives market are massive. Astec Consulting Group Inc. estimated the size of the U.S. securities lending market to be \$1.287 trillion at the end of the second quarter of 2004.⁸⁵ The Bank for International Settlements has estimated that the value of global derivatives contracts exceeded \$450 trillion in 2006.⁸⁶ Transactions in each of these markets generally escape disclosure requirements under the current reporting regime, but would trigger disclosure under Hu and Black’s proposal. Share lenders, in particular, could face a steep increase in compliance costs, as they often lend shares through an agent and are not always informed that shares have been lent.⁸⁷ It is quite plausible, then, that share lenders would need to put new monitoring systems and personnel into place. Finally, substantially increasing derivative reporting in heretofore uncovered industries would add a whole new set of rules that in-house lawyers, compliance officers, derivatives salespersons, and derivatives traders would need to stay abreast of. This would, on average, increase compensation costs for a variety of funds, banks, and other corporations, regardless of whether any of those entities had engaged in or facilitated negative voting behavior. In an industry the size of the derivatives business, this is real money. It is hard to have any sort of confidence that the Hu and Black proposal would reduce costs.

Hu and Black concede that while their proposal “may well be sufficient” as a response to hidden (morphable) ownership, it “may only be a first step” towards curtailing empty voting.⁸⁸ Their disclosure regime only

⁸³ *Id.* at 876.

⁸⁴ *Id.*

⁸⁵ Phyllis Plitch, *Funds’ Lending Sparks “Short” Debate*, WALL ST. J., May 25, 2005, at B2. It is worth noting that this measure includes both equity and debt figures, and that there is little available data on share lending. See Hu & Black, *supra* note 10, at 883.

⁸⁶ Aaron Lucchetti, *In CBOT Fight, It All Adds Up To Derivatives*, WALL ST. J., Mar. 20, 2007, at C1.

⁸⁷ LINTSTOCK, SHARE LENDING VIS-À-VIS VOTING: A REPORT COMMISSIONED BY THE INTERNATIONAL CORPORATE GOVERNANCE NETWORK 3, 22 (2004), available at http://www.icgn.org/documents/share_lending_report_may2004.pdf.

⁸⁸ Hu & Black, *supra* note 10, at 886.

prevents empty voting to the extent that hedge funds and other investors are uncomfortable with their tactics being aired in public. But hedge funds often lack the “reputational risk” concerns that banks and other corporations have. While many corporations have an interest in appearing to be good corporate citizens, especially if they are involved in retail businesses, hedge funds care primarily about their limited partners. Limited partners seek abnormal returns, and many would likely applaud any legal activity that would increase their returns. Hu and Black’s proposal would make it very difficult to engage in negative voting without disclosure, but would do nothing to render it illegal. The analysis in Part I strongly suggests that negative voting is the most destructive of all forms of the new vote buying, yet Hu and Black’s proposal does little to address it.⁸⁹

B. *Ban on Voting Hedged Shares*

David Skeel writes that “[t]he most obvious solution” to vote buying “would be to disqualify the votes of any shareholder who had entered into a contract that protected him from changes in the price of the stock he voted.”⁹⁰ Skeel concedes that this solution is “easier described than achieved” and suggests that its success in curbing vote buying would depend on additional disclosure requirements and on whether courts are willing to disqualify conflicted votes.⁹¹ He is quite right.

Under Skeel’s approach, courts would need to become much more involved in corporate governance in real time. Billion dollar deals often hinge on the outcome of shareholder votes; if prolonged post-vote court battles became a real risk, merger activity would suffer accordingly.

Additionally, the net cast by Skeel’s proposal is too wide. Ordinary shareholders often employ derivatives to hedge their exposure from share ownership.⁹² It is thus hard to conceive of a shareholder vote—in any but the smallest of companies—that would not have some votes disqualified under Skeel’s proposal. The costs of policing thousands of votes each year would likely be substantial.

Furthermore, Skeel’s proposal would curtail both negative voting *and* beneficial instances⁹³ of non-negative voting. This Note argues in Part IV that a more narrowly-tailored regulatory approach is feasible and that it is thus not necessary to throw the baby out with the bathwater.

⁸⁹ This is not to suggest that Hu and Black’s proposal would not be preferable to the status quo. Mandated disclosure of negative voting would reveal how frequently it occurs, and could provide a stepping-stone to more robust preventative action.

⁹⁰ Skeel, *supra* note 6, at 33.

⁹¹ *Id.*

⁹² See Natenberg, *supra* note 53, at 257.

⁹³ See *supra* Part I.B.

C. Ban on Voting Borrowed Shares

One of the largest British pension fund managers, Hermes, has asked regulators to disallow all voting by borrowers of shares.⁹⁴ Such a ban would make both negative voting and non-negative empty voting more difficult because it would remove one of the two means by which entities can obtain voting power.⁹⁵

But this ban would do little, if anything, to prevent negative voters from voting with purchased shares. A negative voter could still buy shares to establish voting power and obtain net negative economic exposure to the stock price through the use of derivatives.⁹⁶

Additionally, implementation of Hermes's proposal would substantially alter the proxy process. For the votes of borrowed shares not to be tallied, share lenders would presumably need to police the proxy process to prevent proxies from being delivered to those who borrowed shares.⁹⁷ Every corporate vote would require monitoring of this sort. If negative voting were to become widespread, such drastic measures might be necessary. Until that is the case, a ban on voting borrowed shares would again seem overbroad.

IV. PROPOSAL FOR REFORM: A PRIVATE RIGHT OF ACTION

Each of the three proposals mentioned above would curtail empty voting behavior. But they would do so in a way that deters both negative voting, which is wealth destructive, and non-negative empty voting, which is arguably beneficial to corporate governance. Two of the three proposals would likely increase costs for parties that have never even engaged in empty voting or hidden (morphable) ownership.⁹⁸ Because negative voting is the most damaging form of new vote buying, regulatory efforts should directly target negative voters and spare both non-negative empty voters and hidden (morphable) owners.

⁹⁴ Kara Scannell, *How Borrowed Shares Swing Company Votes*, WALL ST. J., Jan. 26., 2007, at A9; *see also*, Corporate Government News, <http://corp.gov.net/news/archives2007/Jan.html> (last visited October 19, 2007) (noting Hermes' proposal). A restriction on share lending for what is called "record date capture"—borrowing right before a vote, voting, and returning the shares—is "already the informal norm in the United Kingdom." *See* Hu & Black, *supra* note 10, at 905.

⁹⁵ *See* discussion *supra* Part II.A.

⁹⁶ *See supra* Part II.A. In fact, negative voters can replicate the borrowing of shares by buying shares and entering into a forward sale agreement, which is the approach Perry Capital used to obtain Mylan votes. *See supra* text accompanying notes 6–7.

⁹⁷ For a description of the process by which proxies are distributed from the Depository Trust and Clearing Corporation to brokers and, eventually, to investors, *see* Martin & Partnoy, *supra* note 32, at 795–99.

⁹⁸ The Skeel and Hermes proposals require the disqualification of certain votes. Regardless of whether vote verification would be accomplished by companies or share lenders, the costs of such monitoring would likely be distributed broadly.

This Note proposes that lawmakers create a private right of action under which shareholders harmed by the negative voting of another entity can sue that entity. A plaintiff would establish standing by proving it possessed beneficial ownership of the relevant stock at the time of the shareholder vote at which negative voting is alleged. Once that burden is met, the plaintiff would need to show (1) that the defendant was in fact a negative voter and (2) that the defendant cast votes in a way that caused harm to the plaintiff.

Determining whether a defendant engaged in negative voting is more difficult than it might first seem. While it is often clear whether or not an entity that borrows and sells stock is engaged in negative voting, the picture becomes murkier when entities employ derivatives. For instance, computing the economically-equivalent share position for puts and calls—in industry parlance, the option’s “delta”—requires making projections about future share price volatility, dividend payments, and interest rates.⁹⁹ Different projections will yield different answers to the question, “how many shares is this option position equivalent to?” An entity could be a negative voter under one volatility estimate, but in the clear under a second estimate.

But this problem of “dueling deltas” is not as intractable as it first seems. First, it will only come into play with close calls. Defendants with substantial negative net economic positions will only be able to bring their net position into positive territory with implausible volatility, dividend, and interest rate forecasts. Second, lawmakers can employ a “clear and convincing” evidentiary burden on this point to ensure that only clear cases of negative voting are punished.

To show that the defendant caused the plaintiff harm, the plaintiff would first need to establish that the defendant’s votes had an impact on the outcome of the shareholder vote.¹⁰⁰ If the defendant’s votes had no effect on the vote outcome, the defendant’s voting behavior did not cause the plaintiff any harm. In addition, the plaintiff would need to show that the outcome of the shareholder vote had a negative impact on share price. If the negative voter’s actions helped the plaintiff, the plaintiff should have no right to relief.

Lawmakers can implement this second causation requirement by awarding damages “net of the market.” This damages measure takes the change in stock price between two points in time—for our purposes, the

⁹⁹ For additional discussion of the concept of “delta,” see NATENBERG, *supra* note 53, at 99–103. To see why an option’s delta varies for different volatility and interest rate projections under one common pricing model, see JOHN C. HULL, *OPTIONS, FUTURES, & OTHER DERIVATIVES* 250, 312 (Prentice Hall 2000) (1989).

¹⁰⁰ There are two conceivable rules for determining whether a set of votes altered the outcome of a shareholder vote. One rule would test whether the outcome of a vote would have been different if the votes at issue had not been cast at all. A second rule would test whether changing the votes at issue—from “yes” to “no” or vice-versa—would have changed the vote outcome. The first rule requires a clearer causal link and is thus preferable to the second.

stock price before and after the vote outcome is announced¹⁰¹—and corrects for the change in the broader stock market over that same period. To illustrate, if stock A is down 10% over the relevant period and the broader market—for example, the S&P 500 index—is down 3% over that same period, a damages net of the market approach would award a successful plaintiff 7%.¹⁰² The idea behind this approach is to isolate the damage to shareholder value that the negative vote itself caused, and to render unrelated market moves irrelevant to the damages calculation.¹⁰³

This proposal could conceivably be implemented at either the state or federal level. Because states have an interest in protecting their corporations from destructive negative voting by hedge funds and other entities, they should consider this proposal as a means of making their corporate law more competitive. States have traditionally set their own substantive corporate governance standards,¹⁰⁴ so a state-level implementation of the proposal would seem most natural.

With regard to federal implementation, an initial question is whether the Securities and Exchange Commission (“SEC”) has the statutory authority to implement this proposal. Hu and Black argue that “[t]he SEC likely cannot directly regulate empty voting” because “[s]uch an effort would affect the internal affairs of corporations, traditionally governed by state law.”¹⁰⁵ They cite to *Business Roundtable v. SEC*,¹⁰⁶ in which the D.C. Circuit struck down an SEC rule that barred exchanges from listing companies that undergo dual-class recapitalizations. In *Business Roundtable*, the court found that the SEC had exceeded the scope of its authority when it “step[ped] beyond control of voting procedure and into the distribution of voting power.”¹⁰⁷ These distinctions—between direct and indirect regulation of voting, and between control of voting procedure and control of voting power—give guidance as to, but do not conclusively settle, whether the SEC has the authority to put into place the proposed private right of action. The proposal could be seen as either a direct or indirect regulation of empty voting—“direct” in that it would directly deter certain voting behavior, and “indirect” in that it would neither invalidate votes nor overturn vote out-

¹⁰¹ There are multiple ways to choose the pre-announcement and post-announcement stock prices for this calculation. One logical approach would be to compare the latest pre-announcement opening or closing stock price to the earliest post-announcement opening or closing stock price.

¹⁰² See generally JOHN C. COFFEE, JR. ET AL., *SECURITIES REGULATION* 1122 (10th ed. 2007) (discussing damages net of the market and citing relevant cases).

¹⁰³ This approach works most effectively for stocks that are highly correlated to a broader market index.

¹⁰⁴ Stephen M. Bainbridge, *The Scope of the SEC's Authority Over Shareholder Voting Rights 2* (UCLA Sch. of Law, Research Paper No. 07-16, 2007), available at <http://ssrn.com/abstract=985707>.

¹⁰⁵ Hu & Black, *supra* note 10, at 888.

¹⁰⁶ 905 F.2d 406, 413 (D.C. Cir. 1990).

¹⁰⁷ *Id.* at 411.

comes. The proposal would seem to affect “voting power” more than “voting procedure,” but even its effect on voting power is indirect.

One commentator has approached the question of SEC authority in the realm of corporate governance with the following rule of thumb: “federal law appropriately is concerned mainly with disclosure obligations, as well as procedural and antifraud rules designed to make disclosure more effective” while “regulating the substance of corporate governance standards is a matter for state corporation law.”¹⁰⁸ Under this test, the SEC would probably not be permitted to enact the proposed private right of action because it is neither “concerned mainly with disclosure obligations” nor a “procedural” or “antifraud” rule “designed to make disclosure more effective.” While far from clear, it seems quite possible that courts would invalidate an SEC rule establishing a private right of action for victims of negative voting.

Even if the SEC does not have the authority to establish the proposed private right of action, federal lawmakers do.¹⁰⁹ In the wake of Enron, federal lawmakers made a significant incursion into state corporate law by enacting the Sarbanes-Oxley Act of 2002.¹¹⁰ In the current political climate, however, a rollback—rather than an expansion—of this federalization of corporate law seems more likely.¹¹¹

One final point merits attention. Additional legislation might be necessary to enable plaintiffs to effectively identify the negative voters that caused them harm. While the identity of negative voters could surface by word of mouth¹¹² or from filings made after the vote in question, potential plaintiffs have no simple means of obtaining this information. While shareholders do have access to shareholder lists under certain conditions,¹¹³ those conditions would not be met by plaintiffs in the typical negative voting suit.¹¹⁴ Additional legislation would be necessary to give these plaintiffs access to shareholder lists. Moreover, even with a shareholder list in hand, a potential plaintiff would incur additional search costs in using that list to locate a

¹⁰⁸ Bainbridge, *supra* note 104, at 2.

¹⁰⁹ See William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 624 (2006) (“Congress could draw on the . . . Commerce Clause . . . to occupy the entire field of corporate law.” (citation omitted)).

¹¹⁰ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.)

¹¹¹ See Floyd Norris, *Winds Blow for Rollback of Regulation*, N.Y. TIMES, Dec. 1, 2006, at C1.

¹¹² At least two forces agitate against anonymity on Wall Street: (1) the Wall Street Journal and (2) brokers’ self-interest in spreading information to favored clients. A negative voter’s identity could also surface if it makes any errors in attempting to avoid the web of disclosure requirements detailed in Part II, *supra*.

¹¹³ Exchange Act Rule 14a-7, 17 C.F.R. § 240.14a-7 (2007) (requiring, in the context of a proxy campaign, that a registered company “provide a list of security holders *or* . . . mail the requesting security holder’s [proxy] materials” if certain conditions are met (emphasis added)).

¹¹⁴ A shareholder’s attempt at identifying a negative voter would not be a permissible use of the shareholder list. See *id.* § 240.14a-7(d).

negative voter. Concededly, some harmed parties would abandon their valid claims due to the cost of identifying the negative voter.

V. CONCLUSION

The expansion of the derivatives and stock loan markets has given investors a great deal of flexibility in structuring their voting rights and economic ownership. But some entities have used this flexibility to benefit from decreases in share price that they helped orchestrate. This “negative voting” is the nightmare of corporate governance, for it results in a complete misalignment of voting and economic interests. Current U.S. securities laws allow entities to establish large negative voting positions without disclosure. This loophole in regulation permits negative voters to profit by compelling corporations to choose wealth-destructive options. The more wealth-destructive an option, the more appealing that option is to a negative voter.

This Note has evaluated three separate proposals that would act to reduce negative voting. None of these proposals targeted negative voting directly; all aimed instead at reducing empty voting or both empty voting and hidden (morphable) ownership. If all forms of the new vote buying were equally egregious, these approaches would be appropriate. However, one form of the new vote buying—negative voting—has more potential for wealth destruction than either non-negative empty voting or hidden (morphable) ownership.

The proposal this Note puts forth gives negative voting the attention it deserves, while aiming to spare innocent parties the costs of deterrence. The creation of a private right of action—whether by a federal or state body—would have a minimal impact on current stock loan and derivatives markets, while offering a direct remedy to those who are harmed by negative voting. Here, the most narrowly-tailored legislative approach is probably the best.

