Understanding the (Ir)Relevance of Shareholder Votes on M&A Deals

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The authors are grateful for the comments received in the 2019 Tulane Corporate Roundtable as well as for the research assistance of Mr. Joseph Caputo, Mr. John Kim and Ms. Mary Kate Thompson, in preparing this Article.

Abstract

Has corporate law and its bundles of fiduciary obligations become irrelevant? Over the last thirty years, the American public corporation has undergone a profound metamorphosis, transforming itself from a business with dispersed ownership to one whose ownership is highly concentrated in the hands of sophisticated financial institutions. Corporate law has not been immutable to these changes so that current doctrine now accords to a shareholder vote two effects: first, the vote satisfies a statutory mandate that shareholders approve a deal, and second and significantly, the vote insulates the transaction and its actors from any claim of misconduct incident to the approved transaction. This article takes issue with the courts and commentators who have so elevated the impact of shareholder approval to insulate misconduct. We develop why it is not reasonable to believe that the shareholders' competencies extend to adjudging managerial misconduct, why that conclusion is inconsistent with other modern corporate law developments, and why such shareholder ratification is likely both coerced and poorly considered. We also point out that the position of courts and commentators who pronounce the death of corporate fiduciary law is deeply qualified by the deep conflicts of interest institutional investors face when voting as well as the very real threat that today's ecology that supports shareholder activism is likely to change so that the voice of the discontented shareholder will be at least more muted in the future. Finally, we provide strong empirical support based on a sample of 852 merger deals from 2000 to 2015 that there is a very large thumb on the scale that pushes all deals toward approval, regardless of any allegations of wrongdoing. We observe substantial ownership changes at target corporations, sometimes as high as 40 to 50% of their stock, from long-term investors to hedge funds upon the announcement of a deal and before the consummation of the transaction with a shareholder vote. This change reflects the merger arbitrageurs' actions. We further show that this change in ownership has a positive and statistically significant impact on the likelihood of merger deals garnering the required shareholder approval. We conclude that the Delaware courts need to rethink their obsession with the shareholder vote, renounce the current doctrinal trends that are taking them in the wrong direction, and return to their historic role of evaluating whether directors have satisfied their fiduciary duties in M&A transactions

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UNDERSTANDING THE (IR)RELEVANCE OF SHAREHOLDER VOTES ON M&A DEALS

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ABSTRACT

Has corporate law and its bundles of fiduciary obligations become irrelevant? Over the last thirty years, the American public corporation has undergone a profound metamorphosis, transforming itself from a business with dispersed ownership to one whose ownership is highly concentrated in the hands of sophisticated financial institutions. Corporate law has not been immutable to these changes. Current doctrine now accords to a shareholder vote two effects: first, the vote satisfies a statutory mandate that shareholders approve a deal, and second and significantly, the vote insulates the transaction and its actors from any claim of misconduct incident to the approved transaction.

This Article takes issue with the courts and commentators who have so elevated the impact of shareholder approval to insulate misconduct. We develop why it is not reasonable to believe that the shareholders' competencies extend to adjudging managerial misconduct, why that conclusion is inconsistent with other modern corporate law developments, and why such shareholder ratification is likely both coerced and poorly considered. We also point out that the position of courts and commentators who pronounce the death of corporate fiduciary law is deeply qualified by the deep conflicts of interest institutional investors face when voting as well as the very real threat

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that today's ecology that supports shareholder activism is likely to change so that the voice of the discontented shareholder will be at least more muted in the future.

Finally, we provide empirical support that there is a very large thumb on the scale that pushes all deals toward approval, regardless of any allegations of wrongdoing. We observe substantial ownership changes at target corporations, sometimes as high as 40 to 50 percent of their stock, from long-term investors to hedge funds upon the announcement of a deal and before the consummation of the transaction with a shareholder vote. This change reflects the merger arbitrageurs' actions. We further show that this change in ownership has a positive and statistically significant impact on the likelihood of merger deals garnering the required shareholder approval.

We conclude that the Delaware courts need to rethink their obsession with the shareholder vote, renounce the current doctrinal trends that are taking them in the wrong direction, and return to their historic role of evaluating whether directors have satisfied their fiduciary duties in M&A transactions.

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INTRODUCTION

> [T]he long-standing policy of our law has been to avoid the uncertainties and costs of judicial second-guessing when the disinterested stockholders have had the free and informed chance to decide on the economic merits of a transaction for themselves. There are sound reasons for this policy. When the real parties in interest—the disinterested equity owners—can easily protect themselves at the ballot box by simply voting no, the utility of a litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions on risk-taking than it promises in terms of benefits to them. The reason for that is tied to the core rationale of the business judgment rule, which is that judges are poorly positioned to evaluate the wisdom of business decisions and there is little utility to having them second-guess the determination of impartial decision-makers with more information (in the case of directors) or an actual economic stake in the outcome (in the case of informed, disinterested stockholders). In circumstances, therefore, where the stockholders have had the voluntary choice to accept or reject a transaction, the business judgment rule standard of review is the presumptively correct one and best facilitates wealth creation through the corporate form.[1]

The above quote sets forth the most important development in corporate law in this still very new century.[2] *Corwin v. KKR Financial*

1. Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 312–14 (Del. 2015) (footnote omitted).

2. *See* JAMES D. COX & THOMAS LEE HAZEN, 4 THE LAW OF CORPORATIONS § 23:8 (3d ed. 2010) (noting that "great[] significance" arises from the twin contributions of allowing shareholder approval to supplant enhanced scrutiny that normally applies in *Revlon*-type settings and allowing the mandated vote used to accomplish that transaction also to constitute ratification of the board's conduct); 1A MARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS & FREEZEOUTS § 11.02 (2018) (calling *Corwin* "an important ruling") (on file with authors); STEVEN DAVIDOFF SOLOMON & RANDALL S. THOMAS, *The Rise and Fall of Delaware's Takeover Standards*, *in* THE CORPORATE CONTRACT IN CHANGING TIMES 29–43 (Steven Davidoff Solomon & Randall Stuart Thomas eds., 2019) (reviewing the decline in Delaware judicial scrutiny of M&A transactions, which culminated in *Corwin*'s broad embrace of the cleansing effect of shareholder approval of the transaction); Iman Anabtawi, *The Twilight of Enhanced Scrutiny in Delaware M&A Jurisprudence*, 43 DEL. J. CORP. L. 161, 192 (2019)

Holdings LLC[3] addresses allegations that the directors breached their fiduciary duties by failing to pursue a variety of steps to seek better merger terms.[4] Without considering the substantive merits of this claim, the Delaware Supreme Court dismissed the case solely on the basis that the merger garnered majority shareholder support when they voted on the transaction.[5] Some, including the members of the *Corwin* court, may well believe there are reasons not to be surprised by this result; they see *Corwin* as the natural culmination of the corporate governance movement that began half a century earlier.[6] They can so view *Corwin* as it squarely prefers governance mechanisms—in this case the shareholder vote—and its attendant sense of accountability on the part of managers over a costly and unpredictable resort to the courts to address potential agency costs.[7] Indeed, it is such a view of governance over litigation that elevates the significance of *Corwin*, as it marks not just a natural extension of the trajectory of the modern corporate governance movement but likely its ultimate reach. Moreover, the decision is by the most important court for corporate matters—the Delaware Supreme Court—thus directly affecting the

("*Corwin* has drastically limited the ability of plaintiffs to pursue post-closing fiduciary duty claims against boards of directors in M&A transactions . . . ."); Matthew D. Cain, Jill Fisch, Steven Davidoff Solomon & Randall S. Thomas, *The Shifting Tides of Merger Litigation*, 71 VAND. L. REV. 603, 603–06 (2018) (naming *Corwin* as one of the important developments reducing the availability of shareholder suits challenging deals); Charles R. Korsmo, *Delaware's Retreat From Judicial Scrutiny of Mergers* 30 (Mar. 3, 2019) (Working Paper) (on file with author) (arguing that *Corwin* represents a dramatic development in Delaware law).

3. Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304 (Del. 2015).

4. *Id.* at 306.

5. *Id.* at 312–14. Our focus in this Article is the meaning, and hence relevance, of shareholder votes in deal transactions. This necessarily implicates the soundness of *Corwin*'s holding. What we develop here transcends *Corwin* by challenging the broader assumptions of corporate law, such as the role of a shareholder vote in cleansing self-dealing transactions that we will discuss later. For a close analysis of how poorly *Corwin* fits within corporate law and the numerous significant questions it creates, see generally Franklin A. Gevurtz, Cracking the *Corwin* Conundrum and Other Mysteries Regarding Shareholder Approval of Mergers and Acquisitions (Sept. 19, 2018) (unpublished manuscript), https://ssrn.com/abstract=3252264 [https://perma.cc/SZN3-A73U].

6. *See* Lawrence A. Hamermesh & Leo E. Strine, Jr., *Delaware Corporate Fiduciary Law: Searching for the Optimal Balance*, *in* THE OXFORD HANDBOOK OF FIDUCIARY LAW 871, 887 (Evan J. Criddle, Paul B. Miller & Robert H. Sitkoff eds., 2019) (quoting and endorsing the *Corwin* court's description of the decision as aligned with "the long-standing principle of Delaware law").

7. *See* Zohar Goshen & Sharon Hannes, *The Death of Corporate Law*, 94 N.Y.U. L. REV. 263, 286–87 (2019) (noting that the shift in composition from retail to institutional ownership renders resort to the courts to enforce corporate norms less important as institutional investors—sophisticated, repeat players—can address substantive matters and resort to courts only for procedural matters).

governance of about two-thirds of all public firms[8] and influencing the corporate jurisprudence of other courts.

In this Article, we question the cleansing effect that should follow shareholder approval. We closely examine shareholder consent within the corporate setting and make the case that permitting a shareholder vote to cleanse misconduct—as *Corwin* does—not only misunderstands the meaning of consent but also stands many corporate governance developments of the last fifty years on their head.

To set the stage for our analysis, we note that it is undoubtedly true that our corporate governance system has evolved greatly over the past fifty years. Today, the core focus of the modern corporate governance movement is to establish within public companies a system of independent oversight of the full-time management of the firm. In one of the great social developments of the last half century, public companies morphed rather quickly from having boards dominated by corporate insiders to having a majority of the board members being financially independent of the senior officers; now boards are comprised almost entirely of independent directors.[9] This development coincided with the emergence of financial institutions as a potential forceful voice for shareholder-centric views; this voice grew in force as the equity ownership grew across public companies generally and as ownership of large public companies became concentrated among

8. Adam O. Emmerich & Trevor S. Norwitz, *For Corporate Litigation, Delaware Is Still the First State*, *in* THE INTERNATIONAL COMPARATIVE LEGAL GUIDE TO: MERGERS & ACQUISITIONS 2018, at 7, 7 (12th ed. 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3400258 [https://perma.cc/SVJ3-LQPV].

9. *See generally* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007) (describing the trend and explaining its existence in terms of the interaction between the embrace of enhancing shareholder value as the primary goal of corporate governance and an improved information environment so that firms were driven to improve shareholder wealth rather than accede to wishes of their executives). This movement reflects the underlying belief that in public companies, where ownership is not only separated from management but also where owners can face a formidable collective action problem, boards of directors can provide the necessary oversight of management's stewardship but must be financially independent of management to achieve this objective. *See, e.g.*, 1 PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.01(a) & cmt. c (AM. LAW INST. 1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE] (recommending that at least a majority of the board of large public companies not have a significant relationship with senior managers); MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS § 11 (1976) (describing the importance of the monitoring role of directors and how that role requires financial independence of a critical mass of board members).

financial institutions.[10] Institutional influence has been greatly enhanced by multiple developments that enable them to coordinate their focus: regulatory dispensations so that their public statements regarding their views are no longer a regulated utterance;[11] the evolution of the proxy advisory industry;[12] and the rise of activist investors who regularly tee up proposals for institutions to express their support for actions that increase shareholder value.[13]

Despite these changes, institutional investors sometimes feel that boards—although technically independent of management—are nonetheless not sufficiently shareholder focused. One important reason for this is that regulatory definitions of independence produced by the corporate governance movement are nonetheless porous.[14] In

10. *See* Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89, 91–93 (2017) (collecting data on the concentration of institutional ownership among very large firms); Marshall E. Blume & Donald B. Keim, Institutional Investors and Stock Market Liquidity: Trends and Relationships 4–5 (Aug. 21, 2012) (unpublished manuscript), https://ssrn.com/abstract=2147757 [https://perma.cc/KE39-9G39] (citing literature on the increasing share of equity ownership among financial institutions and confirming the existence of this trend).

11. *See* Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, Investment Company Act Release No. 19,031, 57 Fed. Reg. 48,276 (Oct. 22, 1992) (codified as amended at 17 C.F.R. pts. 240, 249) (liberalizing the announcements that will not be deemed a "proxy solicitation," such as public announcements by shareholders about how they will vote on a matter before the stockholders and offering a voting recommendation by someone, for example, a proxy advisor, who does not solicit proxies); *see also* Jill A. Hornstein, Note, *Proxy Solicitation Redefined: The SEC Takes an Incremental Step Toward Effective Corporate Governance*, 71 WASH. U. L.Q. 1129 (1993) (providing close analysis of the scope of the 1992 amendments to the proxy rules against cases and regulatory provisions that prevailed before the adoption of the reforms).

12. Paul H. Edelman, Randall S. Thomas & Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1397 (2014).

13. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 867 (2013) (making the case that activist investors are governance intermediaries because they formulate convincing business strategies that institutional shareholders are "rationally reticent" to initiate).

14. Just as case law fails to reach social and psychological forces that erode a director's ability to evaluate a fellow director or the firm's CEO critically, *see, e.g.*, Beam v. Stewart, 845 A.2d 1040, 1051 (Del. 2004) (holding that a director is independent to judge claims against a company's CEO even though the director has had long-standing, extensive social involvement with the CEO), standard regulatory provisions defining independence focus on financial dependence and not a range of social and psychological connections that can compromise a director's judgment, *see, e.g.*, NYSE Euronext, Inc., NYSE Listed Company Manual § 303A.02 (2013) (listing financial, commercial, and familial considerations that can render one not independent but not listing any social considerations). More generally, the collegiality of the board necessarily allows social and psychological forces to invite board members to tilt toward management. *See generally* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83 (1985) (analyzing social-

this regard, one significant corporate governance development has been majority-vote bylaws that condition a director serving her newly won term on that director garnering at least a majority of the votes cast.[15] Even this development can be seen as not nearly as empowering to shareholders as their power to nominate individuals to stand for election. Hence, the most recent success of institutional investors is the increasing acceptance by corporations of processes empowering shareholders to nominate some of the director candidates for election.[16] Equally significant is that the well-received practice today is for directors to be elected annually so that they are more accountable to shareholders, hence the cascade of shareholder votes the last few years declassifying boards by amending their articles of incorporation or bylaws.[17] These developments all have a unifying focus: installing individuals on the board of directors who are more independent of management and more aligned with shareholder interests.

The social changes making up this corporate governance movement were reflected in judicial holdings as well, most prominently in Delaware. In what might be considered the Golden Age of corporate

psychological mechanisms among independent directors that generate biases protecting fellow board members against legal sanctions).

15. Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1010–11 (2010) [hereinafter Kahan & Rock, *Embattled CEOs*] (describing the rapid rise of majority-vote provisions among large public companies).

16. *See* Lawrence A. Hamermesh, *Director Nominations*, 39 DEL. J. CORP. L. 117, 127–32, 136–55 (2014) (concluding that the right to nominate directors arises from the statutory power of shareholders to raise proper business at the annual meeting of shareholders and hence can only narrowly be circumscribed by the articles of incorporation or bylaws); Robert C. Pozen, *Institutional Perspective on Shareholder Nominations of Corporate Directors*, 59 BUS. LAW. 95, 96–99 (2003) (proposing that the SEC employ a cost-benefit framework commonly utilized by institutional investors to evaluate proposed rule changes increasing shareholder participation in the nomination of directors).

17. In 2008, only 16 percent of S&P 100 Companies had a staggered board, whereas in 2003, 44 percent of them had staggered boards. Kahan & Rock, *Embattled CEOs*, *supra* note 15, at 1007–09. As the table below reflects, among the largest companies, a classified board is the exception and not the rule.

Board elections	S&P 500	S&P MidCap 400	S&P SmallCap 600	S&P 1500	Russell 3000
Annual elections	88%	65%	58%	70%	61%
Majority voting in director elections	89%	63%	49%	67%	52%

ERNST & YOUNG CTR. FOR BD. MATTERS, CORPORATE GOVERNANCE BY THE NUMBERS (2019), https://assets.ey.com/content/dam/ey-sites/ey-com/en_us/topics/cbm/ey-cgbtn-monthly-june-2019.pdf [https://perma.cc/UAT5-HJ84] (statistics current as of June 2019).

law, Delaware not only resuscitated the directors' duty of care[18] but also established templates by which control could be defended[19] and sold.[20] Delaware further held directors act in bad faith if they have a "sustained or systematic failure" to maintain legal compliance systems.[21] Massive self-dealing transactions such as going-private transactions and incestuous controlling-shareholder-initiated mergers were also subject to a newly minted entire fairness inquiry that includes consideration of not just price but directorial process.[22]

The linchpin of these developments is those courts' wholesale buy-in to the important monitoring role of outside directors—the core feature of the governance movement. Simply put, the quest for directors independent of managers is not an end in itself. It is the correlative obligations for individual directors to advance shareholder interests that is the objective of the movement. Delaware courts stepped forward, as did other courts, in marrying fiduciary duties to the widely received monitoring model.

Those who think of *Corwin* as a natural analog to the above discussion argue that the corporate governance movement is a social force driven by a belief that shareholder interests and protection are best served by an independent and well-informed monitor. From this perspective, *Corwin* takes the expedient course and eliminates the intermediary—the independent board of directors—and in its place rests protection on the palpable force of shareholder self-interest: the majority approval by the owners to a transaction allegedly tainted by fiduciary wrongdoing is the ultimate arbiter of what is in the shareholders' best interest. Therefore, like so many other areas of

18. *See* Smith v. Van Gorkom, 488 A.2d 858, 873–74 (Del. 1985) (establishing that directors exercising informed business judgments is within the duty of care and that the directors acted with gross negligence by hurriedly approving the sale of the company at approximately a 50 percent premium over its publicly traded market price).

19. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955–56 (Del. 1985) (setting forth a two-part test directors must meet when engaging in defensive maneuvers).

20. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (requiring the board to take affirmative steps toward obtaining the best price for the firm when control will be transferred).

21. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970–71 (Del. Ch. 1996) (embracing within the director's monitoring role the duty to have reasonably designed information and reporting systems to assure compliance with the law as well as performance of the company).

22. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 711, 715 (Del. 1983) (substituting an obligation of a controlling person to establish fair price and fair dealing for the formerly used business purpose inquiry).

corporate law, the ultimate rule is the one of majoritarianism whereby the will of a majority of the voting owners carries the day.

We believe that a shareholder vote, such as that which is celebrated in *Corwin*, is misunderstood and that according it with insulating misconduct surrounding the approved transaction not only misinterprets the import of the vote but also distorts the corporate governance developments reviewed above. As such, the emphasis on a shareholder vote unduly insulates from judicial review director and officer failures to act as trustworthy stewards in the sale of their company.

One factor that looms large in our thinking is the overwhelming frequency with which shareholders are relied upon to approve complex—and often conflicted—transactions. If shareholder approval of the deal is the first—and, per *Corwin*, the only—line of defense to managerial misconduct in connection with M&A transactions, we would expect that activist investors would be regularly turning down bad deals. In fact, the record of shareholder voting on such matters is at best ponderous. Empirically, shareholders rarely vote down mergers. We can illustrate this point using data from Professor Morgan Ricks's database on mergers and acquisitions.[23] His data cover all mergers and acquisitions involving U.S. public company targets undertaken after January 1, 1996, and concluded by March 31, 2017. The minimum-size deals included in the database is $1 billion, and there are a total of 1,620 deals included in it. In all, only five deals were rejected by shareholders in a formal vote. In other words, a total of 0.3 percent of all mergers have a failed shareholder vote. An additional seventeen deals were withdrawn before completion, some of which may have been withdrawn because of an anticipated negative shareholder vote. If all twenty-two transactions are counted as shareholder-rejected deals—which is certainly an overestimate—then only 1.3 percent of large mergers fail from lack of shareholder approval.[24]

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23. We thank Professor Ricks for sharing this data.

24. Others have also found that M&A transactions rarely are disapproved by their shareholders. *See* Matteo Gatti, *Reconsidering the Merger Process: Approval Patterns, Timeline, and Shareholders' Role*, 69 HASTINGS L.J. 835, 850–54 (2018) (finding in a study of arms-length mergers involving Russell 3000 firms in 2006–2015 that slightly more than 1 percent failed to obtain shareholder approval); John Mark Zeberkiewicz & Blake Rohrbacher, *Paying for the Privilege of Independence: Termination Fees Triggered by "Naked No Votes*,*"* INSIGHTS: CORP. & SEC. L. ADVISOR, Sept. 2007, at 1, 2 (observing that shareholders rejected only eight out of more than one thousand M&A transactions from 2003–2007).

Other data sets yield the same result. For example, from a universe of fifty going-private transactions instigated by controlling shareholders between 2010 and 2017, Professor Ed Rock isolated seventeen in which the transaction was conditioned on approval by a majority of the minority holders. In none of those transactions did the minority shareholders reject the transaction.[25] Moreover, in his analysis of some of the going-private transactions that involved the agitation against the transaction by an activist hedge fund, Professor Rock noted that all of them ultimately resulted in the activist investors accepting the deal.[26] He explained this as reflecting that activists had no better means to exit from the target company than the one provided by the controlling stockholder.[27]

Finally, there is strong empirical evidence that indicates "management wins all of the close" votes in situations where the board of directors is submitting management proposals for shareholder approval.[28] Professor Listokin's study "examines votes on management-sponsored resolutions and finds widespread irregularities in the distribution of votes received by management."[29] He further notes: "Management is overwhelmingly more likely to win votes by a small margin than lose by a small margin. The results indicate that, at some point in the voting process, management obtains highly accurate information about the likely voting outcome and, based on that information, acts to influence the vote."[30] Though Listokin's data largely involve management-sponsored proposals related to stock options or bonus plans, they do include merger-approval votes that are required by statute.[31] His findings support the argument that managers have a huge advantage in obtaining approval of closely contested merger votes.

The above record of the low percentage of shareholder "NO" votes is equally supportive of two distinct but opposing propositions: (1) the shareholder vote means nothing as they blindly support the deal

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25. Edward B. Rock, *Majority of the Minority Approval in a World of Active Shareholders*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 105, 115–17 (Luca Enriques & Tobias H. Tröger eds., 2019).

26. *Id.* at 121, 124, 127.

27. *Id.* at 129–31.

28. Yair Listokin, *Management Always Wins the Close Ones*, 10 AM. L. & ECON. REV. 159, 172–75 (2008).

29. *Id.* at 159.

30. *Id.*

31. *Id.* at 169–70 & 169 tbl.1.

or, if not blind, will prefer the sparrow in the hand over the pheasant in the bush; or (2) all deals are great deals because the prospect of a vote by the shareholders chastens managers and self-dealing directors to think twice before they submit a suboptimal deal for shareholder approval. In this Article, we put forth empirical evidence and close reasoning to support the first proposition. For instance, as we develop in Part V, after the announcement of a merger agreement, there is a substantial shift of stock into the hands of merger arbitrageurs who are committed to the deal's success and who will invariably vote in its favor. This has a significant effect on the odds of a merger closing, raising the likelihood of deal completion to near certainty in many cases.

We begin by developing several arguments, not considered by *Corwin* and its supporters, regarding why we do not believe that obtaining the statutorily mandated stockholder approval for a transaction is dispositive of whether actionable misconduct on the part of its participants has occurred; simply stated, and as developed below, these are two very different matters that need to be separated. In Part I, we review the well-received views on the relative competencies of shareholders in public corporations to engage in collective decision-making. Our conclusion is that the qualities that equip shareholders to be competent investors in securities are not the same qualities needed to assess whether managers have misbehaved.

In Part II, we challenge a key assumption of *Corwin* that today's environment of shareholder activism, and particularly the forces that have nurtured it over the past twenty years, will continue in the future to be a check on managerial opportunism and slack. In fact, the ecology of shareholder voting in its current coordinated form is under attack and faces strong countervailing forces. Moreover, those championing the cleansing effect of the shareholder voice because of the growing ownership interest of financial institutions must consider that most financial institutions themselves face substantial conflicts of interest that can impact their dispassionate assessment of a matter submitted for shareholder approval. Their conflicts and the compromise they entail in rejecting weak, or even bad, M&A deals are examined in Part III.

Part IV addresses a central concern with any approving vote by the stockholders, namely whether shareholders face a distorted choice so that their will is hardly free, even if informed, and even if they possessed the competencies needed to evaluate all the issues surrounding the transaction that they are asked to approve. In a vote on the proposal to approve the merger that is bundled with approving managerial misconduct committed in the merger process, shareholders have a binary choice of accepting or rejecting the deal. As one commentator put it, "[t]his means that the shareholders' choice ultimately comes down to asking whether the deal before them is better [than] no deal at all."[32] Thus, we develop reasons why the vote absolving managerial misconduct should not be bundled with the vote required for the transaction to occur.

In Part V, we present our empirical analysis of how share ownership among financial institutions shifts materially to short-term investors—largely hedge funds—from medium- and long-term institutional holders. These hedge funds have no interest in litigating corporate management's conduct during the sale process. Instead, they inevitably vote to approve the deal so that they can capture the spread between the deal price and the price at the time of the first announcement of the proposed transaction. We show that this shift places a "thumb on the scale"—in some instances a determinative thumb—in favor of shareholder approval of the transaction.

In Part VI, we examine the role of shareholder votes in self-dealing transactions, a matter excluded, at least presently, by *Corwin*.[33] The presence of self-dealing behavior does not change the conclusions drawn from our data and analysis in Parts I–V; however, when the self-dealing falls within the narrow scope of state conflict-of-interest statutes where shareholder approval is viewed as an alternative the legislature has set forth to address a self-dealing transaction, it is not possible to discard the import of that vote. Nonetheless, as we develop in Part VI, our Article's qualifications to the appropriate meaning of such a vote greatly tempers the ultimate force to be given shareholder

32. Gevurtz, *supra* note 5, at 32; *see also* Korsmo, *supra* note 2, at 7 ("Fundamentally, a merger vote is typically a Hobson's choice—approve the merger as is or reject it altogether—rather than anything resembling a traditional ratification.").

33. Also, our focus in this Article is distinct from the authority provided in corporate statutes for shareholders to ratify lawful acts that nonetheless, when undertaken, were not authorized due to failing to comply with a provision of the applicable corporate statute, a corporation's articles of incorporation or bylaws, or corporate resolution or agreement. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 204–05 (2018); MODEL BUS. CORP. ACT §§ 1.45–.52 (AM. BAR ASS'N 2016). Such provisions provide governance mechanisms, either through approval by the board of directors or shareholders, followed by a filing with the state administrator, whereby a prior unauthorized act, such as issuance of shares that were beyond the number authorized by the articles of incorporation, can be retroactively validated. Such statutory provisions do not validate breaches of fiduciary duty that might accompany corporate transactions of the type that are the focus of this Article.

approval of self-dealing transactions. Our suggestions regarding what to make of shareholder ratification are set forth in our concluding section.

I. INSTITUTIONAL COMPETENCE CONSIDERATIONS

Corporations are not democratic institutions. In a democracy, power flows from the voting populace, and it is this body that is then governed. The populace governs the procedures for selecting candidates for office so that continued service as its elected representative depends heavily on popular support to be the nominee in the election. This is not the case with the corporation. By statute, power over corporate affairs is lodged in the corporation's "governor"—the board of directors.[34] Importantly, the source of the board's power and its legitimacy is derived from the statute and not the shareholders. In addition, the power is exercised over interested parties, such as nonvoting security holders and labor, who do not vote in the election of directors. Indeed, the spheres within which shareholders have authority are limited in number and deeply circumscribed.[35] Like children, shareholders are visible but, per governing statutes, are rarely consulted. Their largest power is their right to turn their elected representatives out of office. But this occurs rarely because of formidable institutional friction. Moreover, shareholder authority to vote for directors is deeply qualified by the fact that they seldom have the authority to nominate directors, and even when this rare power exists, it customarily only permits

34. *See, e.g.*, tit. 8, § 141(a) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . ."); N.Y. BUS. CORP. LAW § 701 (McKinney 2019) ("[T]he business of a corporation shall be managed under the direction of its board of directors . . . ."); MODEL BUS. CORP. ACT § 8.01(a) ("[A]ll corporate powers shall be exercised by or under the authority of the board of directors, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of the board of directors."). Each of these are default provisions that can be changed—but rarely are—by a provision included in the firm's articles of incorporation, and each are subject to discrete provisions set forth in the governing corporate statute that conditions a limited number of transactions, discussed later in this Section, to concurrence by shareholders thereby entitled to vote.

35. For a review of the history of stockholders being relegated to having a vote on so-called fundamental or organic changes as more power over corporate matters was delegated to the board of directors, see, for example, Lynne L. Dallas, *The Control and Conflict of Interest Voting Systems*, 71 N.C. L. REV. 1, 18–28 (1992) (reasoning that shareholder approval is not required for many decisions that rival the importance of mergers or amendments of the articles of incorporation that do require shareholder approval).

shareholders to nominate a distinct minority of the board.[36] Even in instances where a corporation has installed majority-vote requirements as a condition for directors continuing to serve, the only true political voice for shareholders is a negative one.[37] To be sure, stockholder approval is required for so-called fundamental transactions, such as mergers and the sale of substantially all of the company's assets. However, these transactions must be initiated by the board of directors, which controls their timing as well as the information upon which shareholders rely in deciding whether to approve the matter.[38] Each of these features of the process result in the board being the more powerful of the two approving groups.[39]

Other areas of the shareholder franchise are also deeply qualified. The power to sell shares is qualified by the ubiquity of poison pills that constrict takeovers and, accordingly, constrict the opportunities for shareholders to dispose of their shares.[40] Shareholder information rights are also conditioned on, among other considerations, demonstration of a proper purpose for the demand. And when the request is directed toward learning of corporate wrongdoing, this standard is further qualified on allegations of a "credible basis" for

36. *See, e.g.*, SULLIVAN & CROMWELL LLP, PROXY ACCESS: DEVELOPMENTS IN MARKET PRACTICES 2 (2016), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Proxy_Access__Developments_in_Market_Practice.pdf [https://perma.cc/K3RN-6YAH] (reporting that 87 percent of bylaws adopted by two hundred companies in the 2015–16 proxy season limit the number of directors that can be nominated to 20 percent of the board and that 71 percent of those stated the limit was two directors); *see also* Hamermesh, *supra* note 16, at 136–56 (setting forth other limitations that accompany shareholder nominations such as advance notice and background information). *See generally* Kahan & Rock, *Embattled CEOs*, *supra* note 15, at 1019–22 (describing the history of SEC proposals for rules and limitations on proxy access, including only nominating a minority slate).

37. *See* sources cited *supra* notes 15–16 and accompanying text.

38. *See, e.g.*, tit. 8, §§ 251(b), 271(a) (setting forth requirements for a merger or sale of all or substantially all the assets in which stockholder approval of the transaction is required but the shareholder vote only occurs after approval by the board of directors). Under Delaware law, companies also have substantial freedom to manipulate the form of an acquisition to avoid holding a shareholder vote. Hariton v. Arco Elecs., Inc., 188 A.2d 123, 124–25 (Del. 1963) (rejecting the de facto merger doctrine).

39. *See* James D. Cox, *Corporate Law and the Limits of Private Ordering*, 93 WASH. U. L. REV. 257, 270–71 (2015) (noting that before the courts, proposals of the board and those by the shareholders do not stand on the same footing, at least in Delaware, where courts demonstrate more skepticism regarding consequences attached to shareholder initiatives than those by the board).

40. *See* Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 129 (Del. Ch. 2011) (upholding the use of a poison pill to prevent shareholders from tendering shares while recognizing the pill's potential to be abused).

believing wrongdoing has occurred.[41] The final shareholder right is to sue, where, in the case of derivative suits, the shareholder must address the large hurdle posed by the demand requirement.[42] Further, the shareholder may find that the suit is inconveniently lodged in Delaware or another forum favored by the company via a forum-selection bylaw.[43] In light of such serious limitations on the shareholder franchise, *Corwin*'s embrace of not just the virtues but also the paramount force of shareholder approval is at best quaint and most likely seriously misplaced.

There are very good reasons why the shareholder franchise is both limited in scope and deeply qualified. The genius of business organizations is their efficiency, which in large measure flows from enabling individuals with very different skills, experiences, and other endowments to combine with resulting synergies. Business organization law facilitates specialization and, in doing so, accommodates the unique limitations of owners whose personal endowment and circumstances justify their status as owners but not managers of the enterprise. Thus, the dentist with a successful practice will enjoy disposable income that she may profitably invest, but time, skills, and experience justify the dentist having only a passive role in a business organization, as her endowments likely better qualify her for the profession of dentistry than that of being a captain of industry. For

41. James D. Cox, Kenneth J. Martin & Randall S. Thomas, *The Paradox of Delaware's "Tools at Hand" Doctrine: An Empirical Investigation* 10 (Vanderbilt Univ. Law Sch. Legal Studies Research Paper Series, Paper No. 19-10, 2019) (emphasis omitted) (quoting Seinfeld v. Verizon Commc'ns, Inc., 909 A.2d 117, 118, 123 (Del. 2006)), https://bit.ly/36KI7gl [https://perma.cc/K8DQ-U76J]; *see Seinfeld*, 909 A.2d at 123 (reaffirming that access to company books and records so as to determine if misconduct has occurred will be provided if there is a credible showing by "documents, logic, testimony or otherwise" that wrongdoing has occurred). However, in some states access is limited to minutes of board or shareholder meetings and does not extend to general corporate records. *See, e.g.*, Feuer v. Merck & Co., 187 A.3d 873, 878–81 (N.J. Super. Ct. App. Div. 2018) (holding that seeking internal communications among directors bearing on derivative suit demand was outside the scope of documents expressly authorized by statute).

42. There are many permutations to the demand requirement, but regardless of the particular approach, the plaintiff invariably faces a perilous gauntlet to traverse to file a derivative suit. *See* DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE §§ 5:7, :11 (2018) (examining various approaches taken by courts to excuse plaintiffs in a derivative suit from making a demand on the board of directors as a precondition to initiating the derivative suit). For further information on the demand requirement and the use of special litigation committees in place of the full board, see 3 COX & HAZEN, *supra* note 2, §§ 15.7–.8.

43. There is now statutory authorization for forum-selection bylaws after being upheld in *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013). *See* tit. 8, § 115; MODEL BUS. CORP. ACT § 2.08 (AM. BAR ASS'N 2016).

example, business decisions in the extraction of minerals likely are light years away from the skill and experience of the extracting dentist. Moreover, many decisions with respect to engaging in that business must be made more quickly than could feasibly be carried out within even an organization with a modest number of similarly situated owners. Business organization law allows, through either a statute or private ordering, centralization of business decisions in a group that by composition and organization do not face similar time, skill, or experience constraints.

At the opposite end of the decision-type spectrum are transactions that entail an evaluation of the enterprise and, unlike ordinary business decisions, are not seriously time bound. These transactions require investment skills and experience of the type that we can conclude such owners possess by virtue of their having become an owner in a business organization.[44] Examples of such transactions are amendment of the rights, privileges, or preferences enjoyed by owners, the sale of the firm, its acquisition of another firm of at least equal size, and the firm's dissolution. Within the corporate realm, these so-called fundamental transactions must be approved by the firm's stockholders.

Shareholder concurrence for fundamental transactions is justified on twin bases. First, the shareholders have the skill and experience to make such investment-like decisions, as consideration of each type of fundamental transaction elicits heuristics not different from the skills and experience owners are believed to possess and employ when they made their initial investment in the firm. Second, these decisions are not so time bound that the transaction would be jeopardized by the convention of a very large body of owners. In the area of acquisitions, there is a third justification for shareholder voting, namely, that management may be deeply self-interested in the transaction so that the shareholder vote might be a useful prophylaxis.[45]

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44. For a development of why some decisions involve the board of directors or officers and others also include shareholders, see EISENBERG, *supra* note 9, at 12–17, 68. For a fuller development, see Melvin Aron Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CALIF. L. REV. 1, 7–15 (1969) [hereinafter Eisenberg, *The Legal Roles of Shareholders and Management*].

45. Eisenberg, *The Legal Roles of Shareholders and Management*, *supra* note 44, at 27–32. For a fuller discussion of the justifications and limitations of shareholder voting, see generally Edelman et al., *supra* note 12, at 1368–69, 1377–84. The factors developed by Eisenberg are reasons why the endowments of shareholders are believed sufficient to permit participation in decision-making, at some level, in transactions meeting the factors. This understanding of Eisenberg's analysis addresses concern expressed in RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 633–34 (2d ed. 1995), that shareholders

At the same time, some smaller body must be involved in negotiations and resulting refinements for the transaction. To that end, corporate law requires that fundamental transactions are first approved by the firm's board of directors. Note that central to the corporate structure is not just the time dimension but more importantly relative institutional competence. Remote owners face institutional limitations that restrict their approval to transactions that require the same skill and experience that they employed when they became owners in the first instance.

We have genuine concerns, anchored in institutional competence, with the view that the basis for believing shareholders possess qualities that justify their right to approve fundamental corporate changes also support the view that their approving voice should enjoy the same level of deference when that vote is considered as *also* approving misconduct that may have occurred in connection with that transaction. That is, the reasons developed above that underlie shareholder participation being mandated for certain structural transactions are not present when the matter before the shareholders is whether to excuse alleged managerial misconduct.

Our fundamental concern is that when shareholders are asked to approve whether to pursue a claim of misconduct, this entails a very different type of decision than the decision to approve a fundamental transaction where corporate law justifies shareholder action. In describing the characteristics of decisions that can include shareholder approval, Professor Melvin Eisenberg lists matters involving general enterprise-evaluation skills; matters whose magnitude, risks, and time span effect make the matter significant; matters that occur infrequently; and matters that need not be decided quickly.[46] A charge of managerial misconduct in connection with a matter that requires shareholder approval does not appear to us to meet any of these four considerations.

Delaware's own initiative in 1969 to strip any reference to a demand on shareholders from its provision dealing with procedures for

cannot be expected to be intensely involved in the many features of a complex transaction, and therefore that they are not appropriate decisionmakers. Corporate law can be seen as embracing Eisenberg's reasoning while addressing Professors Gilson and Black's concern by conditioning that in acquisitions and other fundamental corporate events, shareholder involvement is not greater than approving or disapproving the transaction formulated initially by the board of directors.

46. Eisenberg, *The Legal Roles of Shareholders and Management*, *supra* note 44, at 10–11.

initiating a derivative suit support our thinking on this.[47] Through the first half of the last century, a precondition to maintaining a derivative suit was that the plaintiff had to either make a demand on the company's shareholders or set forth in the complaint certain well-received bases for why making such a request would be futile.[48] The most prevalent bases for alleging futility was that the conduct challenged in the complaint could not be ratified by a mere majority vote of the shareholders.[49] Generally, a demand on the shareholders was excused when the complaint focused on acts that were fraudulent, illegal, or ultra vires and on allegations that the public nature of the corporation made the demand not practicable.[50] During the second half of the century, such a demand on the shareholders became nearly nonexistent, falling prey to an ever-expanding range of grounds the courts accepted as rendering the requirement futile.[51]

Over the past few decades, law reform efforts, such as the influential American Bar Association Model Business Corporation Act and the American Law Institute Principles of Corporate Governance: Analysis and Recommendations, rejected requiring a demand on shareholders.[52] A central basis for abandoning the requirement is various institutional competence considerations. For all but the private company, the stockholder meeting itself is a highly stylized, nondeliberative event marked by very low attendance relative to the ownership base.[53] In the public company, the true meeting is a virtual meeting that occurs within the electronic solicitation and execution of proxies. Whether shareholders participate by proxy or physically attend the meeting, neither medium is conducive to their undertaking a penetrating engagement of the facts by examining

47. *See* DEMOTT, *supra* note 42, § 5:6.

48. *Id.* §§ 5:2, :3 (noting that even in the states where the requirement has not been abandoned, "[f]ew recent cases ultimately require demand on shareholders").

49. The leading case is *Mayer v. Adams*, 141 A.2d 458 (Del. 1958).

50. *See* DEMOTT, *supra* note 42, § 5:4 (discussing the "practical realities of shareholder decisionmaking"); *id.* § 5:6 (explaining when alleged wrongs are nonratifiable by a majority vote among shareholders); 2 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 9, § 7.03 Reporter's Note 8 (naming practical concerns and nonratifiable conduct as among the reasons modern decisions excuse demand on shareholders).

51. *See* 2 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 9, § 7.03 cmt. h. (reviewing an extensive list of bases developed by the courts to excuse a demand on the shareholders).

52. *Id.* § 7.03(c) ("Demand on shareholders should not be required.").

53. *See* DEMOTT, *supra* note 42, § 5:4 (responding to common justifications for a demand on the shareholders and observing that "[t]he central difficulty with these arguments is that they ignore the practical realities of shareholder decisionmaking in all but the very smallest corporations").

documents, raising questions, or participating in an interchange with other shareholders let alone discussing the facts under applicable law. Moreover, any material revelation that occurs at the meeting would come too late to affect the vast number of proxies earlier cast by a nonattending shareholder. Furthermore, the dominant role of the proxy statement in the shareholder engagement is itself unsettling because the relevant disclosures are so dependent on information prepared at the direction of likely self-interested directors or their designatees. Thus, the American Law Institute ("ALI"), in rejecting a demand on the shareholders as a precondition to initiating a derivative suit, concluded:

> As a general rule, informed collective shareholder consideration of proposed litigation is not feasible. As a body, the shareholders cannot realistically discuss or evaluate the often complex factual and legal issues raised by derivative actions . . . .[54]

In a case considering whether a demand on the shareholders was required in a suit alleging fraudulent behavior, the Delaware Supreme Court was similarly dismissive of shareholder approval of such matters:

> [W]e think it clear that in the ordinary case the stockholders in meeting could not satisfactorily determine the probable merits of a minority stockholder's suit without a reasonably complete presentation and consideration of evidentiary facts. . . . A stockholders' meeting is not an appropriate forum for such a proceeding.[55]

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54. 2 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 9, § 7.03 cmt. h. Even though the ALI eliminated a presuit demand requirement on the shareholders, it did not totally remove shareholders' consent. Section 7.11 calls for a court to dismiss a derivative suit based on the shareholders' approval of a resolution, passed by a disinterested board, in reliance on a thorough and independently prepared report, that dismissal is appropriate, and on the disclosure to the shareholders "of all material facts" regarding the action. The derivative-suit plaintiff is also provided an opportunity to make a brief statement of the plaintiff's views of the action and the pending proposal for dismissal. *Id.* § 7.11 (excluding actions that constitute a waste of company assets). The ALI observes:

> Although it may be argued that shareholders are too disorganized or are too remote from the events to reach an informed decision with respect to a technical issue such as the merits of a pending action, the requirement . . . of ratification by disinterested shareholders plus the waste limitation . . . *helps* to alleviate this problem. Recognition must also be given to the fact that the shareholders are the owners of the corporation, and as such cannot be excluded from a significant voice in deciding matters affecting them.

Id. § 7.11 cmt. c (emphasis added). The comments further observe that such shareholder approval would be most likely relevant in close corporations. *Id.* § 7.11 cmt. d.

55. Mayer v. Adams, 141 A.2d 458, 461 (Del. 1958).

In short, just as a shareholder vote lacks efficacy as a screening device for derivative suits, we believe that the shareholder vote approving a deal should lack any cleansing effect because of institutional competency considerations and because the shareholder forum is ill-suited for addressing whether misconduct occurred.

The institutional investors' use of third-party voting advisors, such as Institutional Shareholder Services ("ISS") and Glass Lewis, to assist them in their voting decisions does not alter this conclusion. These voting advisors are not experts on Delaware law, nor do they have access to the internal information that experienced trial lawyers are likely to have in a full-blown litigation over a breach of the directors' fiduciary duties. Proxy-voting advisors are primarily concerned with assessing whether the proposed merger is superior to no transaction at all for their clients. They do not discuss the preannouncement conduct of the target firm's directors in their recommendations to institutional investors.

Ours is a minority position. The effusive support from contemporary judicial decisions and commentators for the efficacy of shareholder power is an understandable response to the growing concentration of share ownership among institutional investors. The rise and dominance of the institutional investors in capital markets and, more importantly, in ownership of public companies feeds the mechanisms by which corporate developments are efficiently priced and reflected in securities prices, erodes the number of shareholders who are rationally apathetic, and greatly ameliorates concerns about the collective action problem. In combination, the shareholder voice today can be—and is—more frequently heard in the boardroom than at any time in the history of corporate law. In such an environment, it is reasoned that the protective oversight provided by courts is unnecessary:

> [C]orporate law is no longer vital to the regulation of U.S. corporations. The transformation of American equity markets from retail to institutional ownership has relocated control over corporations from courts to markets and has led to the death of corporate law.[56]

56. Goshen & Hannes, *supra* note 7, at 265 (footnote omitted).

The belief supporting this thesis is that "the more competent shareholders become, the less important corporate law will be."[57] This view reflects the increasing frequency of activist shareholders and their concomitant success in pressing headline-grabbing changes with respect to a range of corporate governance items.[58]

We believe, however, that corporate law, much as Mark Twain famously denounced his demise as premature, can rightly claim it has not become superfluous in the era of institutionalized markets. To be sure, we are impressed how in just a few years' time institutional investors have enforced new norms of operation on public companies. Institutional voices have made classified boards of directors the exception and not the rule among large public companies, have led to majority-vote provisions being the norm, have started a trend among large companies for mechanisms to nominate directors, and have turned the poison pill into a vanishing, albeit not extinct, species.[59]

But while some commentators have pointed to these developments as a basis for corporate law becoming irrelevant,[60] it

57. *Id.* at 269; *see also id.* at 289 ("[T]he increased deference of the Delaware courts to market actors reflects the Delaware courts' *correct* understanding that sophisticated shareholders are better positioned to adjudge the merits of board decisions and to discipline disloyalty and incompetence." (emphasis added)). This belief seems deeply qualified by, among other things, the scope of shareholder competence, such as whether it extends only to personal experience with governance or whether it includes the intricacies incident to evaluating whether misconduct occurred in a particular instance. The volition of the shareholder choice in deciding an issue and the richness of the information on which shareholder action is based are two additional considerations.

58. *See* Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610, 620 & tbl.3 (2013) (reporting there were 1,164 hedge fund campaigns between 2000 and 2007 with a 29 percent success rate); *see also* Gilson & Gordon, *supra* note 13, at 867 (developing the basis to understand how the arrival in today's market of the activist shareholder addresses the reticence of many institutional holders to exercise their voting power for changes in governance procedures and operations); *see also generally* Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008) (gathering evidence regarding targets, methods and consequences of hedge fund activism); Brian R. Cheffins, *Delaware and the Transformation of Corporate Governance*, 40 DEL. J. CORP. L. 1 (2015) (reviewing how institutional investors with sizable holdings in companies have successfully targeted a range of corporate changes).

59. The Shareholder Rights Project at Harvard Law School has been actively assisting institutional investors in pursuing these goals over the past several years. SHAREHOLDER RIGHTS PROJECT, http://www.srp.law.harvard.edu/index.shtml [https://perma.cc/TZA8-XF48].

60. *See, e.g.*, Goshen & Hannes, *supra* note 7, at 269, 277–82. And weaknesses in shareholder competence, to some extent, is regularly addressed via proxy advisors. *See* George W. Dent, Jr., *A Defense of Proxy Advisors*, 2014 MICH. ST. L. REV. 1287, 1288–89 (2014) (describing the rise of proxy advisors as a response to collective action problems among shareholders); Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 688 (2005) (reporting on the supplicating steps company

should not be overlooked that their foundations are based on a few fragile organizations that could be wiped away with a regulatory brush. We explore this concern later in Part III. Even in the current regulatory environment, each of these modern corporate governance developments involves shareholder preferences of how they wish to participate in the governance of the firm. None of the matters depends on the assessment of idiosyncratic facts or arcane principles of law regarding a particular individual, event, or firm as do decisions regarding whether misconduct might have occurred and, if so, whether it is reasonable to initiate suit to redress the misbehavior. Simply stated, governance questions such as board declassification involve universal questions regarding the prerogatives of shareholders.[61] Each of these issues—and many others—now dotting the corporate governance menu regularly serve up problems that are well within the competence of the shareholders to consider; because they are so shareholder centric, however, it is not reasonable to conflate such governance developments coming from the force of institutions with the belief that institutional voices can be the sole bulwark against managerial misconduct.

The most basic disconnect committed by *Corwin*-esque thinking is not appreciating that the endowments shareholders are assumed to possess, which justify statutes calling for their approval for fundamental transactions or governance matters, are very different from the skills and experiences required to assess whether shareholder or corporate interests are best served by prosecuting claims that managers have engaged in misconduct. Whether the facts are sufficient to support a claim that the officers or the directors breached a fiduciary obligation when selling the company and whether the shareholder believes twenty-five dollars is acceptable consideration for his shares are both complex questions. Yet as observed above, the latter is no more complex—and requires no more skill—than the initial decision made by the investor to purchase the company's shares at twenty

executives regularly undertake to obtain the approval of governance, compensation, and acquisitions of proxy advisors). This, of course, is also subject to matters of expertise and information constraints that the advisor may have in the particular case.

61. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 570–73 (1990) (identifying antitakeover amendments, confidential voting and greenmail prohibitions among items within the focus of then rising activism of financial institutions); *see also* Kahan & Rock, *Embattled CEOs*, *supra* note 15, at 1005–12 (describing the typical changes in corporate governance as a result of shareholder voting and nonbinding shareholder proposals, including majority elections for directors, de-staggered boards, declassification of boards, and changes to executive compensation).

dollars; the heuristics, whether they be discounted expected cash flow or comparative book values or other inputs into share valuation models, are the same. Alternatively, there is nothing about the cognitive process by which a shareholder became a stakeholder in the firm that mirrors the range of questions presented by a claim of managerial misconduct. The purchase of shares does not require the same skills that are necessary to answer questions regarding the facts that can be established about the alleged skullduggery by managers, the quantifiable harm that can be shown to have occurred, and the associated probabilities with each of these questions. Simply stated, shareholders are investors, not experienced corporate trial judges.

II. THE FRAGILE ECOLOGY OF INSTITUTIONAL SHAREHOLDER VOTING

Those according shareholder approval votes as obviating further inquiry into wrongdoing surrounding the approved transaction assume that the corporate voting system will maintain in its existing form in the future. As shown in this Part, however, that system is fragile, being under attack by corporate management. There is no guarantee that the system will survive that assault, and if it does not, then the intellectual justification for *Corwin* and related cases will disappear. To explain this point, this Part returns briefly to first principles to demonstrate why corporate voting's virility should not be assumed.

A. Key Elements of Institutional Investor Voting System

The basic problem in corporate voting is: Why does anyone vote at all? Investor gains are often tiny, while the costs of becoming informed are significant, even with the mandatory disclosure rules of federal law.[62] In addition, there are significant collective action problems for investors; if there are any benefits derived from voting, then nonvoters garner those benefits too—without incurring the costs of voting.[63] As a result, small investors have little incentive to vote their shares.[64]

62. Edelman et al., *supra* note 12, at 1385.

63. *See* Robert B. Thompson, *The Power of Shareholders in the United States*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER 441, 449–50 (Jennifer G. Hill & Randall S. Thomas eds., 2015) (identifying costs incurred by institutional investors in voting their shares on an informed basis).

64. Apathy among retail investors is a significant concern. Among S&P 500 companies, 21.7 percent of the shares were not voted in 2015. Kobi Kastiel & Yaron Nili, *In Search of the "Absent"*

Institutional investors hold much larger stakes in public corporations today[65] and could, in theory, exert substantial influence over corporate governance issues.[66] These investors can expand their influence by buying more stock, which increases their ability to capture the gains from voting and reduces the uncertainty over the outcome in a contested vote. Their power is limited, however, by the amount of money that they can invest in any particular company as well as legal rules, such as the poison pill[67] and § 16(b) short-swing-profit restrictions.[68] The costs of voting in contested situations are also substantial if institutions wish to win because, not only do they need to be informed, they also have to incur the costs of coordinating the vote and of persuading other investors.

As a result of these burdens, most institutional investors would prefer not to vote on the majority of issues. For example, mutual funds compete with each other on the basis of relative performance; informed voting costs money that cuts into the firm's performance statistics, while any benefits from informed voting accrue to the fund even if it chooses not to vote.[69] To borrow a phrase from Gilson and Gordon, mutual funds are "rationally reticent."[70] That is, they are unwilling to invest in voting because it does not help them attract business and may even cost them in their relationships with current and existing clients. Similar issues arise for other types of institutional investors such that it should not be assumed that if they were left to

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Shareholders: A New Solution to Retail Investors' Apathy, 41 DEL. J. CORP. L. 55, 61 (2016). Evidence that a good portion of this nonparticipation was by retail investors is that substantial increases in the number of nonvoted shares followed regulatory changes in 2009 and 2011 that removed the authority brokers once enjoyed to vote the shares they held in street name when not instructed by their beneficial owners how their shares were to be voted. *Id.* at 61–62.

65. Institutions hold more than 50.6 percent of the stock of the largest 500 American corporations. MATTEO TONELLO & STEPHAN RABIMOV, THE CONFERENCE BOARD, THE 2010 INSTITUTIONAL INVESTMENT REPORT 22 tbl.10, 27 tbl.13 (2010), http://www.shareholderforum.com/e-mtg/Library/20101111_ConferenceBoard.pdf [https://perma.cc/9JYL-D93Z].

66. *See* Black, *supra* note 61, at 570–75 (describing, for example, victories among pension plans in supporting corporate governance proposals as well as institutional shareholders' legislative lobbying efforts).

67. *Id.* at 550–51 (describing poison pill thresholds that set a maximum limit on shareholder ownership in a company).

68. *Id.* at 545 ("Exchange Act section 16 requires . . . 10% beneficial owners of public companies to report purchases and sales to the SEC and to forfeit any 'short swing' profits.").

69. Edelman et al., *supra* note 12, at 1392–93.

70. Gilson & Gordon, *supra* note 13, at 895.

their own devices, they would be interested in actively monitoring corporate management using their voting power.

One significant exception is the activist hedge funds. These funds purchase substantial blocks of targeted companies' stock and then aggressively agitate for changes at the firms.[71] Hedge funds identify value-enhancing, corporate-governance-related strategies and appeal to institutional investors to support them in persuading corporate management to implement them.[72] In addition, other hedge funds frequently follow the lead hedge fund, buying substantial amounts of the targeted firm's stock and then supporting the lead fund in its efforts to bring about corporate governance changes.[73] Top hedge funds' voting initiatives have been very successful even when vigorously opposed by corporate management.[74] Even with the increased presence of hedge funds, however, most institutions are reluctant to spend significant resources on voting initiatives unless required to do so.

Enter the government. In 1988, the Department of Labor declared that institutions subject to the Employee Retirement Income Security Act[75] must vote their stock in a manner that would maximize the value of the fund's portfolio.[76] Failure to do so could result in plan trustees or managers facing regulatory sanctions. The Securities and Exchange Commission ("SEC") passed a similar rule for mutual funds in 2003.[77] Both rules incentivize fund managers to vote their fund's shares even when they might otherwise be tempted not to do so.[78]

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71. Brav et al., *supra* note 58, at 1730.

72. Edelman et al., *supra* note 12, at 1394–95, 1416.

73. *Id.* at 1414–15.

74. *See* C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296, 308–09 (2016) (demonstrating that top hedge funds are quite successful in overcoming aggregate numbers of takeover defenses).

75. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 26 and 29 U.S.C.)

76. Letter from Alan D. Lebowitz, Deputy Assistant Sec'y, Dep't of Labor, to Helmuth Fandl, Chairman of the Ret. Bd., Avon Prods., Inc. (Feb. 23, 1988), 1988 WL 897696.

77. Proxy Voting by Investment Advisers, Advisers Act Release No. 2106, 68 Fed. Reg. 6585 (Feb. 7, 2003) (codified at 17 C.F.R. pt. 275 (2018)) [hereinafter Proxy Voting by Investment Advisers].

78. Recently, however, both the Department of Labor and the SEC have backed away from this requirement and allowed funds not to vote their shares when the costs of voting them exceed its benefits. Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 526–27 (2018).

Faced with a need to vote their shares in an informed manner, but still not wanting to devote large amounts of their staff's time and energy to the endeavor, institutions instead choose to buy voting advice from third-party voting advisors.[79] These proxy-advisory firms specialize in collecting information about upcoming corporate votes, processing it, and providing advice to their institutional clients about how to vote their shares.[80] While many institutions do some of their own research on important votes, they generally rely on proxy advisors to assist them in uncontested situations.

The combination of the mandated institutional voting, third-party proxy advisors' research and voting recommendations, and activist hedge funds initiating contested proxy-voting situations has led the Delaware courts to lionize the corporate voting system and put shareholder ratification on a pedestal.[81] However, as shown in the next Section, corporate management and their advisors, while welcoming the cleansing effect now accorded shareholder ratification, are at the same time urging the federal government, including the SEC, to destroy the carefully built structure on which corporate voting rests.

B. Attacks on Corporate Voting System

Some commentators have suggested that the SEC should reconsider its regulation of institutional investor voting. David Larcker and Allan McCall penned a letter in *The Wall Street Journal* that argued, "[t]he SEC should reconsider the entirety of the shareholder voting process, including the mandate that institutional investors participate in all corporate votes."[82] Their basic point is that institutional investors should be free to make decisions about when it is worthwhile for their beneficiaries to vote at all and that proxy advisor recommendations should be grounded in research that shows they enhance shareholder value.

Corporations have also attacked proxy advisors as too powerful and subject to severe conflicts of interest.[83] Commentators claimed that there is a lack of transparency in how the proxy advisors arrive at their voting recommendations and that there are potential conflicts of

79. Edelman et al., *supra* note 12, at 1397.

80. *Id.*

81. *See* Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 312–14 (Del. 2015).

82. David F. Larcker & Allan L. McCall, *Proxy Advisers Don't Help Shareholders*, WALL ST. J., Dec. 9, 2013, at A17.

83. Edelman et al., *supra* note 12, at 1403–04.

interest when advisory-firm employees serve as directors on boards of companies that the advisors rated.[84] There are claims of direct financial conflicts where, for example, ISS's consulting business markets its services to corporate issuers, giving the appearance that corporate clients might receive more favorable recommendations from the firm.[85]

Partly in response to these issues, the SEC in 2010 raised the question of whether proxy advisory firms should be subjected to regulatory oversight because their voting recommendations impact voting at firms in which they held no economic stake.[86] This issue and others were discussed further at the Proxy Advisory Services Roundtable held on December 5, 2014, where the SEC sought public comment on the services provided by proxy advisory firms, conflicts of interest, and the transparency and accuracy of their recommendations to clients.[87] Subsequently, Congress in 2017 considered the Corporate Governance Reform and Transparency Act, H.R. 4015,[88] which would regulate proxy advisors like ISS and Glass Lewis by requiring them "to register with the SEC and disclose among other things, the procedures and methodologies [they use] to develop proxy voting recommendations and any conflicts of interests."[89] On July 30, 2018, SEC Chairman Jay Clayton announced that a second SEC roundtable on the proxy process would be held.[90] Clayton announced that among the topics to be discussed are proxy advisory firms and whether they suffer from conflicts of interest and lack transparency about their

84. *Id.* at 1404.

85. *Id.*

86. *Id.* at 1403; *see* Concept Release on the U.S. Proxy System, Exchange Act Release No. 62,495, Advisers Act Release No. 3052, Investment Company Act Release No. 29,340, 75 Fed. Reg. 42,982, 43,011 (July 22, 2010) (to be codified at 17 C.F.R. pts. 240, 270, 274, 275).

87. *Proxy Advisory Services Roundtable*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/spotlight/proxy-advisory-services.shtml [https://perma.cc/Q4MZ-U3Z7].

88. Corporate Governance Reform and Transparency Act of 2017, H.R. 4015, 115th Cong. (2017).

89. Steve Seelig & Puneet Arora, *The Regulation of Proxy Advisors*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Aug. 3, 2018), https://corpgov.law.harvard.edu/2018/08/03/the-regulation-of-proxy-advisors [https://perma.cc/UD42-5NV5] (stating that the legislation is "widely supported" by the U.S. Chamber of Commerce and the Business Roundtable).

90. Jay Clayton, *Statement Announcing SEC Staff Roundtable on the Proxy Process*, U.S. SEC. & EXCHANGE COMMISSION (July 30, 2018), https://www.sec.gov/news/public-statement/statement-announcing-sec-staff-roundtable-proxy-process [https://perma.cc/LSS5-C822]; *see also* David A. Katz & Laura A. McIntosh, *Proxy Voting and the Future of Corporations*, LAW.COM: N.Y. L.J. (Nov. 28, 2018, 2:46 PM), *available at* https://www.law.com/newyorklawjournal/2018/11/28/proxy-voting-and-the-future-of-corporations [https://perma.cc/JQ8H-J6ZU] (summarizing the testimony and viewpoints of the participants of the roundtable).

voting recommendations.[91] The Senate Committee on Banking, Housing, and Urban Affairs also held a full committee hearing on these issues.[92]

In the meantime, on September 13, 2018, the SEC withdrew two staff advisory letters that address the independence of proxy advisory firms under SEC Rule 204 (4)-6 ("the Rule").[93] The SEC stated that the letters were withdrawn in order to facilitate meaningful comments from the public in anticipation of its upcoming roundtable.[94] However, according to *The Wall Street Journal*, the withdrawal came after six

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91. Clayton elaborated on areas that might "warrant particular attention":

- Whether various factors, including legal requirements, have resulted in investment advisers to funds and other clients relying on proxy advisory firms for information aggregation and voting recommendations to a greater extent than they should, and whether the extent of reliance on these firms is in the best interests of investment advisers and their clients, including funds and fund shareholders.
- Whether issuers are being given an appropriate opportunity to raise concerns if they disagree with a proxy advisory firm's recommendations, including, in particular, if the recommendation is based on erroneous, materially incomplete, or outdated information.
- Whether there is sufficient transparency about a proxy advisory firm's voting policies and procedures so that companies, investors, and other market participants can understand how the advisory firm reached its voting recommendations on a particular matter, and whether comparisons of recommendations across similarly situated companies have value.
- Whether there are conflicts of interest, including with respect to related consulting services provided by proxy advisory firms, and, if so, whether those conflicts are adequately disclosed and mitigated.
- The appropriate regulatory regime for proxy advisory firms and whether prior staff guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms should be modified, rescinded, or supplemented.

Clayton, *supra* note 90 (footnote omitted).

92. DAVID A. KATZ & LAURA A. MCINTOSH, WACHTELL, LIPTON, ROSEN & KATZ, SENATE COMMITTEE HOLDS HEARING ON PROXY VOTING PROCESS 1 (Dec. 7, 2018), https://www.thecorporatecounsel.net/nonmember/docs/12_07_18_proxy.pdf [https://perma.cc/ZWZ7-H65Q].

93. The SEC issued a statement concerning the withdrawal of the two letters. *Statement Regarding Staff Proxy Advisory Letters*, U.S. SEC. & EXCHANGE COMMISSION (Sept. 13, 2018), https://www.sec.gov/news/public-statement/statement-regarding-staff-proxy-advisory-letters [https://perma.cc/GGG3-N2EJ]. The withdrawn letters are: Egan-Jones Proxy Services, SEC No-Action Letter, 2004 WL 1201240 (May 27, 2004) [hereinafter Egan-Jones Letter]; Institutional Shareholder Services, Inc., SEC No-Action Letter, 2004 WL 2093360 (Sept. 15, 2004) [hereinafter ISS Letter].

94. *SEC Withdraws Two No-Action Letters Regarding the Use of Proxy Advisory Firms – Chairman Clayton Issues Statement Regarding Staff Views*, ROPES & GRAY (Sept. 19, 2018), https://www.ropesgray.com/en/newsroom/alerts/2018/09/SEC-Withdraws-Two-No-Action-Letters-Regarding-Use-of-Proxy-Advisory-Firms-Chairman [https://perma.cc/UNW9-RW4B] [hereinafter ROPES & GRAY, *SEC Withdraws Two No-Action Letters*].

Republican senators asked the Government Accountability Office to determine whether the SEC overreached in issuing the two letters.[95]

The Rule regulates when investment advisors may vote their client's securities.[96] When it was adopted in 2003, the SEC stated that an investment advisor could meet its duties under the Rule, thereby proving that their vote of the client's securities was not a product of a conflict of interest, by demonstrating that the advisor voted the proxies in accordance with procedures based on the recommendations of an "independent" proxy advisory firm.[97] The withdrawn letters detailed in what situations a proxy advisory firm might be considered independent.[98] Clearly, the SEC is actively considering completely rewriting the rules that regulate proxy advisors. More pointedly, the letters' withdrawal was a barometer in forecasting political headwinds for proxy advisors.

These forecasts proved accurate when, on August 21, 2019, the SEC voted 3–2 along party lines to approve new guidance for proxy voting by investment advisors and proxy advisory firms.[99] Although the precise impact of these new guidelines is still being debated as this

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95. Dave Michaels, *Public Companies Score a Win in Fight To Limit Reach of Proxy Advisers*, WALL ST. J. (Sept. 13, 2018, 3:23 PM), https://www.wsj.com/articles/public-companies-score-a-win-in-fight-to-limit-reach-of-proxy-advisers-1536862260 [https://perma.cc/H29Z-MCNK].

96. ROPES & GRAY, *SEC Withdraws Two No-Action Letters*, *supra* note 94 ("Th[e] Rule . . . ensure[s] that investment advisers vote proxies in the best interest of their clients and provide clients with information about how their proxies are voted.").

97. *Id.* ("[T]he SEC stated that an investment adviser could demonstrate that its vote of its clients' proxies was not a product of a conflict of interest if the adviser voted the proxies in accordance with a pre-determined policy based on the recommendations of an 'independent' proxy advisory firm.").

98. *Id.* The Egan-Jones Letter confirmed that a proxy advisory firm could still be considered independent, even if it has been given compensation by a corporate entity being evaluated for other services. *Id.* The ISS letter stated that neither an individual nor a case-by-case evaluation of a proxy advisory firm's conflict procedures was necessary, but that instead an investment advisor may determine that a proxy advisory firm is able to make independent decisions by reviewing its conflict procedures overall. *Id*.

99. Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Company Act Release No. IC-33605, 84 Fed. Reg. 47420 (Aug. 21, 2019), https://www.sec.gov/rules/interp/2019/ia-5325.pdf [https://perma.cc/MA7W-ED3P]; Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice, Exchange Act Release No. 34-86721, 84 Fed. Reg. 47416 (Aug. 21, 2019), https://www.sec.gov/rules/interp/2019/34-86721.pdf [https://perma.cc/9B84-TBLM]; *SEC Issues Guidance To Clarify Investment Advisers' Proxy Voting Responsibilities and the Treatment of Proxy Advice Under the Proxy Rules*, ROPES & GRAY (Aug. 20, 2019), https://www.ropesgray.com/en/newsroom/alerts/2019/08/SEC-Issues-Guidance-to-Clarify-Investment-Advisers-Proxy-Voting-Responsibilities [https://perma.cc/G228-YFBW].

Article goes to press, "[b]usiness groups that pushed for such changes, including the U.S. Chamber of Commerce and the National Association of Manufacturers, applauded the SEC's action, while advocacy groups such as the Council for Investor Rights and Corporate Accountability said [they] would limit shareholders' ability to hold companies accountable."[100] As Commissioner Allison Herren Lee stated, the new guidance first "introduces increased costs and time pressure into an already byzantine and highly compressed process. Second, it calls for more issuer involvement in the process despite widespread agreement among institutional investors and investment advisors that greater involvement will undermine the reliability and independence of voting recommendations."[101] Finally, we note that those who believe the institutional investor voice can substitute for state fiduciary duty law, such as appears to be the case in some Delaware cases,[102] speak of an era that appears to be changing. The era that appears to be passing is one where a great many large institutions relied on proxy-advisor expertise rather than their own. The recent developments at the SEC suggest a reversal of this practice, although it is hard at this point to gauge fully its impact.

In addition to new regulations for proxy advisors, consider the future of the dominant activist investor. Hedge fund activists' leadership on voting initiatives rests upon their ability to generate value for themselves and other shareholders. However, whether hedge funds increase value is a hotly contested question. Their detractors argue that, while there are often short-term value increases associated with hedge fund activism, these gains come at the expense of the long-

100. Andrew Ramonas & Andrea Vittorio, *SEC Answers Pleas To Rein in Proxy Firms ISS, Glass Lewis (2)*, BLOOMBERG L. (Aug. 21, 2019, 11:27 AM), https://www.bloomberglaw.com/document/X7M77JQS000000?bna_news_filter=securities-law&jcsearch=BNA%25200000016caf89d2d0a1fdffb933c30001#jcite [https://perma.cc/MCR9-DRJZ].

101. *Statement of Commissioner Allison Herren Lee on Proxy Voting and Proxy Solicitation Releases*, U.S. SEC. & EXCHANGE COMMISSION (Aug. 21, 2019), https://www.sec.gov/news/public-statement/statement-lee-082119 [https://perma.cc/YR68-FFFP].

102. *In re* Pure Res., Inc. S'holder Litig., 808 A.2d 421, 444 (Del. Ch. 2002) ("[C]orporate law should not be designed on the assumption that diversified investors are infirm but instead should give great deference to transactions approved by them voluntarily and knowledgeably."); *see* Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 313–314 (Del. 2015) ("When the real parties in interest—the disinterested equity owners—can easily protect themselves at the ballot box by simply voting no, the utility of a litigation-intrusive standard of review promises more costs to the stockholders in the form of litigation rents and inhibitions on risk-taking than it promises in terms of benefits to them.").

term value of the targeted companies.[103] Prominent corporate attorney Martin Lipton has argued that the omnipresent threat of hedge fund interventions has led corporate management to manage companies for the short term rather than focusing on long-term value enhancement.[104] Moreover, even if hedge funds generate value, they do so at a significant cost: hedge fund managers are extremely well paid for their efforts, typically receiving 15–20 percent of net fund profits and a 1–2 percent management fee on invested funds.[105] Despite their fee structure, successful hedge fund managers have been able to attract institutional investors to invest in their funds and have frequently been able to persuade them to vote in their favor in contested situations.[106]

However, there are also regulatory initiatives that would adversely affect hedge funds that the SEC has recently considered. One proposal that has been debated actively is to reduce the ten-day waiting period for early warning Rule 13d filings to shorten the number of days that hedge funds have before they must disclose their positions in targeted firms.[107] While this proposal was not adopted, there continues to be substantial pressure on regulators from corporate management and their supporters to weaken activist hedge funds.[108]

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103. Martin Lipton, *Dealing with Activist Hedge Funds and Other Activist Investors*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Jan. 26, 2017), https://corpgov.law.harvard.edu/2017/01/26/dealing-with-activist-hedge-funds-and-other-activist-investors [https://perma.cc/74CD-P59W] ("There are, however, encouraging signs that major investors are increasingly concerned that hedge-fund activism is undermining long-term value, and that they are ready to support well-run companies and their long-term strategies against short-term activist attacks."). One recent study found that in the long-term, hedge fund activism had no significant effect on firm value. Ed deHaan, David Larcker & Charles McClure, *Long-Term Economic Consequences of Hedge Fund Activist Interventions* 7, 18–23 (ECGI Working Paper Series in Fin., Working Paper No. 577/2018, 2018), https://ssrn.com/abstract=3260095 [https://perma.cc/P54U-GM5X].

104. *See* Lipton, *Dealing with Activist Hedge Funds and Other Activist Investors*, *supra* note 103 (stating that non-hedge fund investors, as a result of hedge fund activism, have begun to support companies in their long-term strategies to resist "short-term activist attacks").

105. *See* Edelman et al., *supra* note 12, at 1408 (discussing the compensation incentives of hedge fund managers).

106. *See id.* at 1415–18 (detailing institutional investors' support for hedge fund activism).

107. *See* Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39 (2012) (highlighting the SEC's proposal to shorten the current waiting period).

108. *See, e.g.*, Adam O. Emmerich, Theodore N. Mirvis, Eric S. Robinson & William Savitt, *Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure, and the Use and Abuse of Shareholder Power*, 3 HARV. BUS. L. REV. 135, 137 (2013) (discussing and defending a petition from Wachtell, Lipton, Rosen & Katz to the SEC arguing that the 13(d) disclosure rules should be changed from ten days to one day).

To summarize this discussion, each of the critical links in the corporate voting system, which has been lauded by the Delaware courts as providing investor oversight of managerial conduct in sales of the firm and in controlling-shareholder self-dealing, is under attack. Losing any one of these important planks—mandatory institutional voting, well-informed proxy advisors, or hedge fund leadership on corporate voting issues—will have a devastatingly negative impact on the effectiveness of shareholder monitoring via their voting power. Proponents of shareholder ratification as a cleansing device for managerial misconduct, such as Wachtell Lipton,[109] often appear to be simultaneously lobbying to undermine the foundations of effective shareholder voting.[110] We would hope that the Delaware courts would at least be sensitive to the dangers that these "reform" efforts will have on the effectiveness of corporate voting as a ratification device.

III. CONFLICTED VOTING CASTS DOUBT ON THE LEGITIMACY OF SHAREHOLDER RATIFICATION

Ratification voting frequently suffers from conflicts of interest.[111] When this happens in a merger, the shareholders voting—often large institutional investors—may not be voting to maximize the value of the

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109. *See, e.g.*, William Savitt, *Wachtell Lipton Discusses Post-Closing Merger Litigation—The Road Ahead*, COLUM. L. SCH.: CLS BLUE SKY BLOG (Jan. 28, 2019), http://clsbluesky.law.columbia.edu/2019/01/28/wachtell-lipton-discusses-post-closing-merger-litigation-the-road-ahead [https://perma.cc/AD4V-Z3MD] ("The evolving doctrine affirms the view that, with sophisticated institutional investors now dominating equity markets, the courts can (and as a matter of efficiency should) avoid extensive litigation-driven second-guessing in the great run of transactional situations.").

110. For example, three Wachtell Lipton partners state:

> Although the [SEC Commissioner's] guidance does not eliminate the fundamental structural concerns that such vast power has been given to a small group of companies that own no shares, are largely unaccountable and appear to have business imperatives to create ever-evolving "best practices," it will hopefully lead to more thoughtful and responsible use of proxy voting advice and propel further action to ensure greater disclosure regarding conflicts of interest, lack of transparency and other concerns that have been expressed concerning the proxy advisory industry.

David A. Katz, Trevor S. Norwitz & Sabastian V. Niles, *Wachtell Lipton Discusses SEC Regulatory Guidance on Proxy Advisory Firms and Proxy Voting Responsibilities*, COLUM. L. SCH.: CLS BLUE SKY BLOG (July 2, 2014), http://clsbluesky.law.columbia.edu/2014/07/02/wachtell-lipton-discusses-sec-regulatory-guidance-on-proxy-advisory-firms-and-proxy-voting-responsibilities [https://perma.cc/W376-4HFQ].

111. *See generally* Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. REV. 1151 (2019) (discussing institutional investor conflicts of interest in the context of mutual fund intermediaries).

target firm but rather to further some other interest.[112] In this Part, we focus on some of the key conflicts of interest that emerge. We argue that these conflicts impact a significant percentage of the shares voted to approve mergers, undercutting the claim that the approval vote reflects shareholders' preferences to absolve corporate management of legal liability.

A Institutional Conflicts of Interest

Private corporate pension plans are run by trustees who are selected by the management of the firm whose employees are the fund's beneficiaries.[113] The private pension fund can be invested in the sponsoring company's stock and, not surprisingly, will vote those shares in a manner designed to please corporate management.[114] More broadly, the managerial orientation pervades private pension funds so that the funds tilt heavily toward supporting the management of portfolio companies.[115] In a merger, private pension funds will probably vote their shares in favor of the transaction, even where it may not be a value-maximizing deal. This is especially true if they have a bigger investment in the target than the bidder.[116]

Mutual funds also face conflicts that arise from employers' control of what funds will be available for their employees for retirement planning.[117] Employers have wide latitude to decide which funds they offer to their workers. As a result, mutual fund managers are reluctant to vote their shares against the wishes of corporate management and, more generally, are hesitant to earn a reputation of being antimanagement.[118] In the context of a merger, target and acquirer

112. *See* Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877, 887 (2010) ("Institutional intermediaries and their decision-makers hold a variety of complex economic interests that challenge their incentive to maximize firm value.").

113. Edelman et al., *supra* note 12, at 1401.

114. *See* Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552, 554, 568–69 (2007) (giving examples of mutual funds' conflicts of interest in corporate governance and finding "that the more business ties a fund company has, the less likely it is to vote in favor of shareholder proposals that are opposed by management").

115. *See* Edelman et al., *supra* note 12, at 1401 (suggesting that ties between pension plan managers and corporate managers could affect funds' voting).

116. *Id.*; *cf.* Griffith & Lund, *supra* note 111, at 1175.

117. *See* Edelman et al., *supra* note 12, at 1402–03; Griffith & Lund, *supra* note 111, at 1178–79.

118. *See* Edelman et al., *supra* note 12, at 1402–03 ("Employers can choose from a wide variety of funds and fund managers and are loath to cast votes that might cause employers to cut off their access to employees' retirement money.").

management both wish to see the deal approved, providing a powerful incentive to mutual fund managers to vote favorably on the deal. Additionally, mutual funds with a reputation of not supporting the management of their portfolio firms face challenges when hawking their services to corporate managers as desirable components of a firm's retirement options for its employees. Given the huge size of the mutual fund market, it is frequently the case that collectively these funds are the largest single voters on the transaction.[119]

Labor union pension funds may suffer from a different type of bias in a merger context: they may seek to maximize the value of labor's share of the deal rather than maximizing the value of shareholders' returns in the transaction.[120] This problem arises because labor union shareholders wear two hats: they generally vote like other shareholders on issues that do not affect them in their capacity as workers, but in situations where they are voting on issues that affect their jobs or future as workers in a company, they may well vote in their interests as workers at the expense of shareholders.[121] In some mergers, where the acquirer seeks to eliminate workers by reducing benefits, union shareholders may have a strong interest in voting against the transaction even though it is value increasing for shareholders.[122]

Public pension plans, such as CalPERS, may also have a different type of conflict. Their trustees are often politicians or political appointees. The political interests of a fund's trustees may lead them to direct merger votes in a way that maximizes their own welfare, even though it does not increase the value of their fund's stock holdings.[123] This may cause the fund to promote politically valuable transactions at the expense of its own beneficiaries by approving value-decreasing mergers.[124]

SEC rules contain provisions that require funds in these circumstances to have policies and practices to explain how the funds

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119. *Id.* at 1386, 1387 tbl.1. The high degree of market concentration in the mutual fund business may mitigate this conflict, as the largest funds may be less concerned about losing a single client because of a merger. *Id.* at 1403.

120. *See* Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1075–77 (1998) (discussing various conflict-of-interest issues that arise in the context of labor union pension funds).

121. *Id.* at 1074 ("On the one hand, [labor unions] could be attempting to increase firm value in order to maximize their residual share as shareholders. On the other hand, they could be sacrificing their shareholder value in order to protect jobs or otherwise help their members.").

122. *Id.*

123. *See* Fisch, *supra* note 112, at 883 (providing examples of this conflict).

124. *Id.*

resolve material conflicts of interest.[125] Under these rules, investment advisors have a fiduciary duty to vote the securities held by their funds under practices and policies that ensure their votes are cast in their beneficiaries' best interest.[126] However, these rules are weakly enforced with few resources devoted toward identifying violations and little enforcement activity.[127]

B. Proxy Advisors' Conflicts of Interest

Institutional investors generally hold diversified portfolios of stocks in order to minimize the risks that are associated with any individual firm's securities. For larger institutions, this could mean that they own thousands of different companies' stocks and have voting obligations at a huge number of corporate meetings.[128] In order to comply with their fiduciary obligations, the institutional investor would need to devote a considerable amount of its staff's time to digesting corporate proxy statements—even in routine voting situations—which consequently increases its operating costs.[129] To avoid reducing returns to investors and beneficiaries, institutions retain third-party voting advisors, such as ISS and Glass Lewis, to assist them in performing their voting duties.[130] These proxy advisors analyze the proxy information that companies supply to their investors and then formulate voting recommendations for their institutional clients.[131] In some cases, these firms actually vote the clients' shares on their behalf pursuant to certain voting policies.[132]

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125. *See* Proxy Voting by Investment Advisers, *supra* note 77 (describing required policies and procedures under rule 206(4)-6).

126. Edelman et al., *supra* note 12, at 1396.

127. *Id.*

128. *See id*. at 1397 (referencing "tens of thousands of votes cast each year" at large institutions).

129. Letter from Jonathan Feigelson, Senior Vice President, Gen. Counsel & Head of Corp. Governance, Teachers Ins. & Annuity Ass'n of Am. & Coll. Ret. Equities Fund ("TIAA-CREF"), to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Nov. 8, 2010), http://www.sec.gov/comments/s7-14-10/s71410-263.pdf [https://perma.cc/E2MQ-XJSR] ("Though we dedicate a significant amount of resources to corporate governance research and the voting of proxies, we still would have difficulty processing the 80,000 plus unique agenda items voted by our staff annually without utilizing [proxy firm] research.").

130. Edelman et al., *supra* note 12, at 1397–99.

131. *See, e.g.*, *The ISS Advantage*, INSTITUTIONAL SHAREHOLDER SERVS., https://www.issgovernance.com/about/about-iss [https://perma.cc/QW8W-LC2G] (discussing the process by which proxy advisors provide services to their clients).

132. *Id.*

As seen in the preceding Part, critics have argued that proxy advisors should be subject to SEC regulation because they influence voting at companies where they have no economic stake.[133] These same critics have further stated that proxy advisory firms are not transparent about how they formulate their voting recommendations, that they may have political biases, and that they may sit on corporate boards of companies while making recommendations to their clients about how that stock should be voted.[134]

More importantly, in some instances, the proxy advisors—notably ISS—appear to suffer from conflicts of their own. Namely, these advisors are selling services to the very corporate issuers whose shares they are directing other institutional clients about how to vote.[135] Issuers are concerned that their willingness to purchase these services from ISS may indirectly influence the voting recommendations issued by ISS.[136] Despite ISS's claims that they have built an internal wall between these two pieces of its business—and its institutional investors clients' apparent satisfaction with those efforts—the potential for this conflict remains a topic of great interest to corporate issuers.[137] To the extent that this conflict, or the others identified in the preceding paragraph, results in institutional investors voting their shares partly or wholly in reliance on tainted recommendations, there is the potential for shareholder-ratification votes to deviate from what is in the best interests of the shareholders of the target firm.

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133. *See, e.g.*, Letter from Tom Quaadman, Exec. Dir., Fin. Reporting & Inv'r Opportunity, Cent. for Capital Mkts. Competitiveness, to Mary Schapiro, Chairman, U.S. Sec. & Exch. Comm'n (Aug. 5, 2010), https://www.sec.gov/comments/s7-14-10/s71410-26.pdf [https://perma.cc/AY9K-FPQF] (criticizing proxy advisors' involvement in the voting process); James R. Copland, Opinion, *Politicized Proxy Advisers vs. Individual Investors*, WALL ST. J. (Oct. 7, 2012, 7:06 PM), https://www.wsj.com/articles/SB10000872396390444620104578012252125632908 [https://perma.cc/9CT2-9JSS] (same).

134. Copland, *supra* note 133.

135. Edelman et al., *supra* note 12, at 1404.

136. *Id.* ("ISS has a separate consulting business on voting issues that is marketed to issuers. Issuers that purchase those services may improve their chances of getting a favorable recommendation from ISS . . . .").

137. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 10-11 (2007), https://www.gao.gov/assets/270/263233.pdf [https://perma.cc/4CPZ-DVCM] (describing institutional investors' satisfaction with ISS's mitigation of potential conflicts and the additional steps institutional investors take to ensure ISS's independence).

C. Empty Voting

In addition to the practices examined earlier in Part I, many hedge funds hold large positions in target companies when the acquisition is announced.[138] Such holders sometimes resort to sophisticated financial-hedging strategies to eliminate their financial interest in the target firm whilst retaining their voting rights on the merger.[139] This is one dimension of a phenomenon called "empty voting."[140] In a simple case, if the hedge fund holds shares in the target firm while simultaneously selling them short, they can retain a vote on the transaction yet still benefit from a decline in the target's stock price.[141] This would give the fund an incentive to vote against the merger even when it is value maximizing for other shareholders. Conversely, the hedge fund could structure the transaction so that it benefits from approving a merger that is value decreasing for other shareholders.[142] In both of these situations, the ratification vote may stem from the hedge fund's conflict of interest and not from any view it has about potential managerial misconduct.

The true extent of empty-voting transactions is unknown, and there are relatively few instances that have been publicly disclosed.[143] However, such hedging has expanded with the growth of sophisticated securities-derivatives markets.[144] Given the importance of hedge funds as a driver of M&A activity in today's markets, it seems likely that they will find themselves in this position in the future.

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138. *See* Edelman et al., *supra* note 12, at 1409 (noting that, on average, hedge funds take larger ownership stakes in target companies than other types of investors).

139. *See* Griffith & Lund, *supra* note 111, at 1172–73.

140. Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 815 (2006).

141. *See id.* at 828 (providing examples of empty voting through purchases of hedged shares); Edelman et al., *supra* note 12, at 1406 ("By holding shares in a corporation while simultaneously selling them short, an investor can retain a vote in the corporation yet still benefit from a decline in the price of the stock.").

142. *See* Edelman et al., *supra* note 12, at 1406 (stating that empty voting can "lead to a vote that does not maximize firm value").

143. Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 652, 659 (2008) ("How much decoupling activity is there? Without effective disclosure, we don't know."). For several examples of publicly disclosed empty voting, see Edelman et al., *supra* note 12, at 1405–06 & n.207.

144. *See generally* Hu & Black, *supra* note 143 (stating that the emergence of over-the-counter equity derivatives permits the separation of voting rights from economic interest to occur quickly).

D. Cross-Ownership Conflicted Voting

As another investment strategy, some activist hedge funds have frequently taken large positions in target company stocks in merger transactions.[145] In some of these cases, the hedge funds have purchased positions in both the target and the acquirer, and they have voted their stock in a manner that maximizes the value of their overall portfolio.[146] This form of voting conflict has been called a "cross-ownership conflict."[147] The empirical evidence shows that the ownership splits that underlie these conflicts are rampant in our economy.[148] For example, "share ownership has become so concentrated that 'in a hypothetical conflict between two S&P 500 firms in 2005, 15% of the equity in either firm would on average be held by institutional investors that prefer the other side to win.'"[149]

Mutual funds frequently find themselves in this position as well because they hold diversified portfolios that contain shares of many different stocks.[150] Many of their passively managed index funds hold stakes in virtually all public companies of any size.[151] When these funds hold shares in both the target and the acquirer, they vote their shares in both companies to maximize the overall value of their portfolio.[152] In mergers between two public companies, the mutual fund needs to weigh the impact of the merger on both parties to the transaction. Its

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145. As we demonstrate in Part V *infra*, a substantial amount of target company stock is controlled by merger arbitrageurs. *See infra* Table 3. For additional discussion of merger arbitrage, see sources cited *infra* notes 225–28.

146. *See generally* Jarrad Harford, Dirk Jenter & Kai Li, *Institutional Cross-Holdings and Their Effect on Acquisition Decisions*, 99 J. FIN. ECON. 27 (2011) (finding a rapid increase in such "cross-holdings" and exploring their effect on value-reducing transactions).

147. *See* Griffith & Lund, *supra* note 111, at 1172.

148. *Id.* at 1173.

149. *Id.* (quoting Ann M. Lipton, *Shareholder Divorce Court*, 44 J. CORP. L. 297, 310 (2018)).

150. *Id.*

151. *See* Edward Rock & Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders* 1 (Law & Econ. Research Paper Series, Working Paper No. 18-39, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3295098 [https://perma.cc/SKS2-S8D4] ("Index funds . . . have grown to be the largest investors in the capital markets and have received disproportionate attention."); John C. Bogle, *Bogle Sounds a Warning on Index Funds*, WALL ST. J. (Nov. 29, 2018, 10:15 AM), https://www.wsj.com/articles/bogle-sounds-a-warning-on-index-funds-1543504551 [https://perma.cc/N4MX-X84G] (noting that index funds control, not just own, a large fraction of the vote in U.S. corporations—almost 30 percent—and that if the trends continue, those funds will control virtually all); Jordan Wathen, Vanguard's Founder Warns That Index Funds Could Become Too Big to Function, MOTLEY FOOL (Dec. 1, 2018, 6:00 PM), https://www.fool.com/investing/2018/12/01/vanguards-founder-warns-that-index-funds-could-bec.aspx [https://perma.cc/B2EM-4TCQ] (same).

152. *Id.*

fiduciary duties require it to vote its stock to maximize the value of its beneficiaries' interests.[153] In other words, it must weigh both the impact of the deal on the acquirer and its frequently opposite effect on the target. If the stock value of a mutual fund's acquirer is increasing by a sufficient amount to offset its portfolio's losses to the target company, then the fund could very well vote its shares in favor of the transaction that is a negative wealth-creating deal for the target.[154] Furthermore, this effect is magnified by some mutual funds' practice of voting all of the shares in their entire family of funds in the same manner, even when some of its individual funds may have differing economic interests.[155]

There is some empirical evidence that supports the claim that this cross-ownership conflict is a significant issue for ratification purposes. A recent study by Brooks, Chen, and Zeng found that institutional cross-ownership between firms increases the likelihood of the two firms merging but also reduces the deal premium that is paid in the deal.[156] They also found that cross-holders were more likely to vote for mergers that had negative announcement returns, while mutual funds without cross-holdings were more likely to vote against them.[157] This suggests that cross-holders' shareholder-ratification votes in mergers may be favorable for target management but at the expense of the target company's shareholders.

The preceding review of existing conflicts that confront each category of institutional investors erodes any confidence that shareholders vote in a manner that increases their common good. These conflicts are consistent with the voting results in deal transactions reviewed in the next Part.

IV. CONFOUNDING THE PROBLEM: THE CASE OF DISTORTED CHOICE

The institutional limitations reviewed above—limits on the individual endowments of shareholders, inherent boundaries of their acting in a forum that necessarily prevents meaningful engagement of

153. *See* Proxy Voting by Investment Advisers, *supra* note 77.

154. *See* Griffith and Lund, *supra* note 111, at 1174.

155. *See id.* at 1170–71 (discussing high uniformity in voting across funds, even when the views of portfolio managers differ).

156. Chris Brooks, Zhong Chen & Yeqin Zeng, *Institutional Cross-Ownership and Corporate Strategy: The Case of Mergers and Acquisitions*, 48 J. CORP. FIN. 187, 189 (2018).

157. *Id.* at 212.

the issues, and conflicting interests that shareholders can face—are not the only problems with according shareholder approval a cleansing role. An equally looming malady with contemporary corporate norms is that courts allow the shareholder approval of the transaction to excuse any misconduct managers may have committed in connection with that transaction. Simply stated, the norm celebrated in *Corwin*, followed in other contexts in Delaware and well received outside of Delaware, is that it is permissible to bundle in a single resolution the deal's approval as well as a concurrent vote excusing managerial misconduct that occurred or may have occurred during that transaction.

A. *Inherent Coercion*

For shareholder approval to shield management adequately from accusations of wrongdoing, a threshold requirement is that the approval not be coerced.[158] Decisions that treat a shareholder vote approving the transactions as also surrounding that transaction with presumptions of the business judgment rule,[159] as *Corwin* did, bundle two related but profoundly distinct issues into a single resolution. This Section examines whether such a bundled resolution itself is corrupted because the resulting stockholder approval is the product of a distorted vote that combines a positive-value resolution—the merger—with a negative-value item—absolving managers of failing to secure a better transaction. Inherent in finding a distorted choice is that the decision entails at least some level of coercion. However, the courts have yet to explore the meaning of coercion fully in the context of shareholder voting on mergers.

Sciabacucchi v. Liberty Broadband Corp.[160] illustrates the limits of a court's engagement with the issue of coercion. In acquiring Time Warner Cable and Bright House Networks, Charter Communications entered into two contracts: one involving the issuance of shares and another granting a proxy to its largest stockholder, Liberty Broadband.[161] Charter conditioned the two lucrative acquisitions on a vote by the disinterested shareholders approving both the share

158. Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 308–12 (Del. 2015).

159. *Id.* at 313 (supporting the reasoning of its holding as "tied to the core rationale of the business judgment rule").

160. Sciabacucchi v. Liberty Broadband Corp., No. 11418-VCG, 2017 WL 2352152 (Del. Ch. May 31, 2017).

161. *Id.* at *4.

issuance and the proxy transactions.[162] Following shareholder approval, Matthew Sciabacucchi, a Charter stockholder, initiated a shareholders' suit challenging the share issuance and proxy as unfair to Charter and the product of a breach of fiduciary duty by its director and largest stockholder.[163] Charter moved to dismiss the case, arguing that because the share issuance and the proxy transactions had been approved by a majority of disinterested Charter stockholders, they were presumptively valid.[164] The Court of Chancery rejected the argument, stating: "[R]atification will not cleanse a transaction where the vote is *structurally* coercive."[165] It defined a vote as "structurally coercive" when "the directors have created a situation where a vote may be said to be in avoidance of a detriment created by the structure of the transaction the fiduciaries have created, rather than a free choice to accept or reject the proposition voted on."[166] The court elaborated on this position:

> "Coercion" is a loaded term, but a vote so structured by the Defendants, to accept one (allegedly self-interested) transaction so as not to lose the benefit of another independent transaction, cannot to my mind be considered uncoerced. . . . The stockholders did not decide, necessarily, that the Liberty Share Issuances and the Voting Proxy Agreement were "in their best interest," they only decided that the Acquisitions *and* the Issuances and Voting Proxy Agreement were, on net, beneficial. The facts are sufficient to an inference that the Liberty Share Issuances (and the Voting Proxy Agreement) were unnecessary to the Acquisitions. If so, and if such a vote were cleansing, then fiduciaries could attach self-dealing riders to any transaction under consideration, and avoid being held to account by a favorable stockholder vote. That is not equity; it would represent, not a cleanse, but a white-wash.[167]

We do not believe it is a long step—indeed, we view it as a logical step—to view the shareholders' approval of a merger with awareness that such approval cures any possible misconduct in the transaction as similarly coercive. Just as in *Liberty Broadband*, an approving vote can only be seen as consistent with the view shareholders accorded their approval of both the acquisition and its accompanying misconduct as

162. *Id.* at *5.
163. *Id.* at *6.
164. *Id.*
165. *Id.* at *2.
166. *Id.*
167. *Id.* at *4.

"on net, beneficial."[168] It is not reasonable to believe the legal consequence of such bundling should turn on whether there are separate, interconnected resolutions, as in *Liberty Broadband*, or a single resolution. Coercion arises in both instances by virtue of their being bundled together.

B. Bundling in the Courts

Ratification finds its roots in the law of agency, where it developed as a series of processes for the principal to become legally bound by the unauthorized acts of her agent.[169] Thus, most of agency law's focus is on correcting the agent's lack of authority and not directly on approving or excusing the agent's unfaithful or reckless tortious acts. In the latter situation, with a single or only a few principals, misconduct by the agent can be examined as in any other area where individual bargaining is possible. As the enterprise becomes larger in terms of more owners and layers of authority, the principal–agent analogy becomes at least attenuated, if not breaking down entirely.[170]

A business entity with multiple owners is a very different setting than the single-principal-single-agent setting. The corporate context is even more removed from the classic agency model: officers and directors are not agents of the owners and, as seen above, the owner's prerogatives and endowments are more limited than the classic principal's powers in the law of agency. Nonetheless, share ownership, however otherwise circumscribed, has long carried with it the power to

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168. *Id.*

169. *See* RESTATEMENT (SECOND) OF AGENCY § 82 (AM. LAW INST. 1958).

170. *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997), continues to be the most thoughtful corporate decision addressing shareholder ratification. Chancellor Allen denied the defendants' motion to dismiss a suit challenging Mattel's stock-option plan as wasteful and self-interested after the plan had been approved by the stockholders. *Id.* at 329. The opinion usefully explains the possible ways to conceptualize a ratifying vote of the shareholders:

> [Ratification] provides, after the fact, the grant of authority that may have been wanting at the time of the agent's act. Another [way of conceptualizing ratification] might be to view the ratification as consent or as an estoppel by the principal to deny a lack of authority. In either event the effect of informed ratification is to validate or affirm the act of the agent as the act of the principal.

Id. at 334–35 (citation omitted).

Lewis also observes that flowing from the fiduciary relationship between the principal and the agent are requirements that the ratification be preceded by full disclosure and that there is no coercion of the approval. *Id.* at 335. Chancellor Allen emphasized how the collective decision of numerous shareholders complicates the ratification vote in comparison to the single principal context of the law of agency. *Id.* He observed that this causes corporate law to make two important adjustments: the approving vote must exclude the vote of self-interested parties, and shareholders lack the authority to approve corporate waste. *Id.*

ratify managerial and controlling-stockholder misconduct, such that it is now a cornerstone of corporate law that a fully informed, noncoerced vote of the stockholders is a proper ratification. What varies across states are the types of misconduct that is beyond ratification and the effect that such shareholder approval has on matters like the burden of proof and the legal standard by which the conduct will be judged. Our initial focus is not on either of these questions. We instead make the point that courts have rushed to embrace the substantive niceties of ratification—full disclosure, no coercion, and effects of an approving vote—but have failed to consider fully the threshold question: Should ratification occur only in a freestanding vote?

The ALI's corporate governance project deals with shareholder ratification in only two discrete contexts: shareholder resolutions approving dismissal of a derivative suit[171] and shareholder approval of self-dealing transactions.[172] The ALI approach on the question of bundling, however, is different in each of the two settings. When dealing with the process and effect of shareholder approval of self-dealing, the ALI comment states in its definition of "disinterested shareholder[]" approval in Section 1.16 that "[i]f a shareholder vote is required to be and is taken to authorize a transaction under applicable state corporation statutes, it can be combined with a vote under § 1.16."[173] Although the use of "combined" leaves open the question of whether this refers to a combination in a single resolution so that bundling is contemplated, the ALI confines the consequences of any approving vote to overcoming adverse inferences that historically attach to self-dealing transactions where organic corporate law requires shareholder approval of the transaction. In contrast, dismissal of a derivative suit as a consequence of shareholder approval must, per the ALI, occur in a separate resolution that clearly sets forth the factual

171. 2 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 9, § 7.11.

172. 1 *id.* § 1.16 cmt. c.

173. *Id.* The other important law reform effort is the American Bar Association's Model Business Corporation Act, which takes no express provision on bundling, but it should be read as permitting the resolution involving a "conflicting interest transaction" to be the same shareholder approved resolution as required for the transaction to be affected. *See* MODEL BUS. CORP. ACT §§ 8.61(b)(2), .63(a) (AM. BAR ASS'N 2016) (requiring that the transaction is duly noticed as requiring shareholder approval, the conflicted director discloses to the corporation of shares the director believes are interested in the transaction, and there is full disclosure of material facts); *see also id.* § 8.60(7) (broadly defining the disclosure required in conflict of interest transactions). The Model Act is clear that its technical provisions address only the "conflicting interest transaction" and not the board's failure "to conform with general standards of director conduct." *Id.* § 8.61 cmt. 2.

and legal issues surrounding the matter.[174] Therefore, within the ALI scheme, bundling that involves misconduct that neither supports a derivative action nor involves classic forms of self-dealing is not addressed directly.

The great bulk of deal-driven litigation falls within this large lacuna neglected by the ALI. This type of litigation focuses on lapses in processes pursued by directors or officers in their carrying out the transaction. We are thus left to surmise which of the two strands of thinking embraced by the ALI should guide a court's consideration of bundling. We believe there are bases to believe that the ALI puts a heavy thumb on the scale against bundling, or at least against according an approving shareholder vote full, insulating qualities. First, the ALI's treatment of self-dealing transactions can be seen as burden-shifting mechanisms because, even after an admittedly fully informed disinterested vote, the plaintiff still can pursue a claim that the transaction was so one-sided as to constitute waste.[175]

Second, the nonbundling choice for dismissal of derivative suits—an inquiry into the transaction's fairness—is much closer to the type of issues posed in the ratification at the heart of deal-generated litigation where the issue is whether managerial misconduct occurred in a corporate transaction. The central considerations for fairness in self-dealing have historically been whether there was ample disclosure of the insider's interest in the transaction and whether the transaction was financially fair.[176] Financial fairness is assumed to be the central focus of shareholders who are asked to approve an organic transaction. However, fairness is not at the heart of claims based on inadequate processes pursued by directors to approve the transaction. The transaction could easily be within a range of fairness, but managerial misconduct could still have harmed the shareholders by not securing a price higher up within the range that fairness spans. Thus, although the fairness prong of the self-dealing inquiry may be satisfied, the

174. 2 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 9, § 7.11(a) (addressing procedures whereby a derivative suit can be dismissed upon approval of the shareholders and calling for "[*a*] *resolution* recommending such dismissal" (emphasis added)). The provision mandates that the resolution submitted to the stockholders be the product of a fully developed examination by the board of directors or committee of the directors sufficient to support a court dismissing the suit were the recommendation made by the directors. *Id.* (linking the resolution's content to the procedures set forth in §§ 7.09(a)(1)–(3) and 7.10(a)).

175. *See, e.g.*, 1 *id.* § 5.02(a)(2)(D) (stating that the duty of fair dealing is satisfied where, *inter alia*, the transaction does not constitute waste).

176. *See, e.g.*, *In re* Wheelabrator Techs. Inc. S'holders Litig., No. 11495, 1992 WL 212595, at *2–9 (Del. Ch. Sept. 1, 1992) (evaluating a motion to dismiss with this standard).

managers might still face a claim that even better terms could have been garnered for the shareholders but for their misconduct.

Third, in the section that the ALI devotes to the conduct of shareholder litigation, nonbundling was embraced. Thus, were a derivative suit filed for management misconduct in a self-dealing transaction, for which the defense is impartial ratification by the shareholders, dismissal of that suit because of a vote by the shareholders could only occur if there was an unbundled vote that was preceded by preparation of an extensive report supporting such dismissal. This conclusion appears to be driven by the distinction made above between shareholder approval of the fairness of a transaction and the more complicated situation involving shareholder evaluation of a suit for misconduct. The latter certainly requires a richer process, reflected in the ALI requirement that shareholder approval in those situations occur in a truly independent and fully informed procedure.

Much of corporate doctrine takes its cues from Delaware. And until recently, Delaware has not been much help to sister states on the question of bundling; indeed, students of Delaware jurisprudence have witnessed something of a ping-pong match among colliding jurists.[177] Though many Delaware decisions touch upon the topic of ratification,[178] fewer cases consider whether bundling erodes the efficacy of shareholder approval. In *Corwin*, its most recent pronouncement on bundling, the Delaware Supreme Court crisply stated "this Court has never held that the stockholders had to be asked separately to '"ratify' the board's actions for" their approval to invoke the business judgment rule.[179] Just a few years earlier, the same court in *Gantler v. Stephens*[180] reached a very different result, observing that:

> [T]he scope of the shareholder ratification doctrine must be limited to its so-called "classic" form; that is, to circumstances where a fully informed shareholder vote approves director action that does *not*

177. For over three decades, Delaware case law regarding the doctrine of shareholder ratification has been marred by "confusion." *See* J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny*, 40 WM. MITCHELL L. REV. 1443, 1445 (2014) (explaining that Delaware courts had undergone an effort "to clarify confusion inadvertently created by loose language about stockholder ratification in *Smith v. Van Gorkom*").

178. *See, e.g.*, Williams v. Geier, 671 A.2d 1368, 1384 (Del. 1996); Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992); Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985), *overruled by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009); *In re* Lukens Inc. S'holders Litig., 757 A.2d 720, 736–38 (Del. Ch. 1999).

179. Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 311 n.24 (Del. 2015).

180. Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

> legally require shareholder approval in order to become legally effective. Moreover, the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve.[181]

Gantler was responsive to reasoning used by the Delaware Supreme Court in *In re Santa Fe Pacific Corp. Shareholder Litigation*,[182] which itself reversed a Delaware Court of Chancery decision authored by then-Vice Chancellor Jack Jacobs, the subsequent author *Gantler*.[183] In *In re Santa Fe Pacific Corp. Shareholder Litigation*,[184] the plaintiff alleged that the board of directors breached its duty of care by failing to disclose all material facts connected to the merger and breached its *Revlon* and *Unocal* duties by quashing the Union Pacific deal.[185] The Court of Chancery held the fully informed, uncoerced shareholder approval automatically extinguished all claims against directors.[186] The Delaware Supreme Court reversed, holding:

> In voting to approve the Santa Fe-Burlington merger, the Santa Fe stockholders were not asked to ratify the Board's unilateral decision to erect defensive measures against the Union Pacific offer. The stockholders were merely offered a choice between the Burlington Merger and doing nothing. The Santa Fe stockholders did not vote in favor of the precise measures under challenge . . . . Since the stockholders of Santa Fe merely voted in favor of the merger and not

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181. *Id.* at 713.

182. *In re* Santa Fe Pac. Corp. S'holder Litig., 669 A.2d 59 (Del. 1995).

183. *See id.* at 62–63 (reversing in part the decision of the Delaware Chancery Court). In *Gantler*, First Nile's board determined that the corporation should "put itself up for sale." 965 A.2d at 700. First Nile's management team, on the other hand, encouraged the board to abandon its search, proposing instead a privatization plan. *Id.* Nevertheless, the board continued to identify bidders, two of whom offered First Nile shareholders a premium over market price. *Id.* Management, however, took actions to obstruct these bidders from moving forward with the process and instead developed a privatization proposal intended to benefit incumbent board members. *Id.* at 700–01. While one lone board member dissented, the rest of the board voted in favor of the proposal, which required shareholder approval of an amendment to move forward. *Id.* at 702. Just 50.28 percent of disinterested shareholders voted in favor of the proposal. *Id.* at 703. This is an example of management winning the "close ones." *See* Listokin, *supra* note 28.

184. *In re* Santa Fe Pac. Corp. S'holder Litig., No. 13587, 1995 WL 334258 (Del. Ch. May 31, 1995), *aff'd in part, rev'd in part*, 669 A.2d 59 (Del. 1995).

185. *Id.* at *5.

186. *Id.* at *8 ("Under Delaware law, a fully informed shareholder vote ratifies a challenged transaction and operates to extinguish any claim that the directors breached their fiduciary duty of care in connection with that transaction.").

> the defensive measures, we decline to find ratification in this instance.[187]

By holding that the vote approving the merger could *not* also ratify director misconduct, the Delaware Supreme Court reversed the pro-bundling facet of then-Vice Chancellor Jacobs's decision in the Court of Chancery.

Delaware's current embrace of bundling was achieved as a result of distinguishing *Gantler* and *Santa Fe Pacific* as cases not involving full disclosure, a factor not emphasized in either of those decisions.[188] More sweeping is that Delaware jurisprudence has lurched forward in allied fronts so that the presence of a disinterested shareholder approval of a transaction invokes the business judgment rule in a wide range of self-

187. *In re* Santa Fe Pac. Corp., 669 A.2d at 68.

188. Chief Justice Leo Strine, the author of the Delaware Supreme Court's decision in *Corwin*, before his elevation to that court, boldly stated that he believed *Gantler* was wrongly decided. He observed that:

> In a merger where there is no controller and the disinterested electorate controls the outcome from the get go, . . . it has long been my understanding of Delaware law, that the approval of an uncoerced, disinterested electorate of a merger (including a sale) would have the effect of invoking the business judgment rule standard of review. . . . It may be that a vote in that context does not involve "pure ratification," *see Gantler v. Stephens* . . . but I have long understood that under our law it would invoke the business judgment rule standard of review.

In re S. Peru Copper Corp. S'holder Derivative Litig., 52 A.3d 761, 793 n.113 (Del. Ch. 2011) (citation omitted). Strine's opinions, throughout his career as a vice chancellor, chancellor, and Chief Justice, are remarkably consistent in his acceptance of the cleansing effect of a bundled vote. However, we believe his opinions in the wake of *Gantler* and before his own opinion in *Corwin* reflect an excessively dismissive view of antibundling precedent. *See, e.g.*, Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304 (Del. 2015); *In re* MFW S'holders Litig., 67 A.3d 496 (Del. Ch. 2013); *In re* S. Peru Copper Corp., 52 A.3d 761.

Throughout his long judicial career, Strine has been consistent in his embrace of bundling so that even a statutorily compelled vote invokes the immunizing effects of the business judgment rule if the vote is fully informed and not coerced. *See In re* S. Peru Copper Corp., 52 A.3d at 793–94 (holding that even though the case involved a vote of a majority of the disinterested shareholders following full disclosure, the vote did not invoke the business judgment rule in a merger with its 63.08 percent holder; Chancellor Strine reasoned that the approval was meaningless because the merger required only two-thirds approval so that the minority shareholders likely did not believe their vote would be meaningful); *In re* PNB Holding Co. S'holders Litig., No. 28-N, 2006 WL 2403999, at *15 (Del. Ch. Aug. 18, 2006) (explaining that had the cash-out merger been approved by a majority of disinterested shares, the ratification would have cleansed the transaction); *In re* Gen. Motors Class H S'holders Litig., 734 A.2d 611, 621 (Del. Ch. 1999) (reasoning that stockholders' choice to approve an amendment of the articles of incorporation "carried with it a concomitant obligation on the part of the voters to accept responsibility for the outcome" and therefore was not coercive and ratified any alleged misconduct); Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 890 n.36 (Del. Ch. 1999) (stating that the shareholder approval of the merger accorded "burden-shifting ratification effect").

dealing settings.[189] No recent Delaware Supreme Court decision addresses the historic role of ratification as a concept involving approval of the agent's conduct and not the transaction that is the product of that conduct.[190]

C. Federal Proxy Rules

Prior to 1992, proposals within proxy statements that were disseminated to shareholders could be grouped together so long as the proposals were "related."[191] However, in October of 1992, the SEC altered the manner in which proxy resolutions are to be presented and voted upon.[192] Among the suite of reforms adopted was Securities Exchange Act Rules 14a-4(a)(3) and (b)(1)—the "unbundling rules"—which require proxy forms to "identify clearly and impartially each *separate* matter intended to be acted upon"[193] and to provide shareholders with the "opportunity to specify by boxes a choice between approval or disapproval of, or abstention with respect to each

189. *See In re* MFW, 67 A.3d at 499, 536, *aff'd*, Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014) (holding that a cash-out merger with a firm's 43 percent owner enjoys the presumptive validity of the business judgment rule when effected by a fully informed uncoerced vote of the disinterested shareholders following negotiation and approval by a fully independent negotiating committee); *In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 424, 445 (Del. Ch. 2002) (holding that the business judgment rule's presumption applies when a controlling stockholder carries out a short-form merger after obtaining, through a noncoercive tender offer, shares tendered by a majority of the minority with disclosure that if the requisite 90 percent ownership is obtained via the tender offer, the short-form merger will be consummated at a price equal to the tender offer price).

190. In *Lewis v. Vogelstein*, Chancellor Allen qualified his ratification discussion by noting that, because the stock-option plan could become effective without shareholder approval, the principles he applied would not apply were the vote one required by statute: "I first note that by shareholder ratification I do not refer to every instance in which shareholders vote affirmatively with respect to a question placed before them. I exclude from the question those instances in which shareholder votes are a necessary step in authorizing a transaction." 699 A.2d 327, 334 (Del. Ch. 1997). In an earlier decision, *Braunschweiger v. American Home Shield Corp.*, No. 10755, 1991 WL 3920 (Del. Ch. Jan. 7, 1991), Chancellor Allen, in a transaction that required shareholder approval, demurred whether a fully informed uncoerced vote would "constitute[] a defense to plaintiffs' claims of breach of fiduciary duty, or merely shift[] the burden to plaintiffs to prove the unfairness of the transaction." *Id.* at *7. In that case, because Chancellor Allen was able to avoid resolving the bundling question because he found that the directors had failed to disclose all material facts so that the shareholder approval had no effect, it is difficult to conclude whether there was an evolution in his thinking on the propriety of bundling. *See id.*

191. Rule X-14A-2(a) of the Securities Exchange Act required that shareholders receive the right to vote "on each matter, *or* each group of *related* matters as a whole." Amended Proxy Rules, 3 Fed. Reg. 1991 (Aug. 13, 1938) (emphasis added).

192. 17 C.F.R. § 240.14a-4(a)(3) (1993). The rules were proposed in Regulation of Communications Among Securityholders, 57 Fed. Reg. 29,564 (proposed July 2, 1992).

193. 17 C.F.R. § 240.14a-4(a)(3) (emphasis added).

separate matter referred to therein as intended to be acted upon, other than elections to office."[194] Essentially, the unbundling rules require that shareholders be able to vote separately on each matter set forth in a proxy. These changes were made in an effort to improve communication between shareholders, managers, and others soliciting proxies and to remove unnecessary limitations on shareholders' exercise of their voting rights.[195]

Although shareholders may now communicate their approval or disapproval with respect to each matter on proxy forms to solicitors, the implementation of these proposals is still allowed to be "conditioned" on the approval of other proposals at the discretion of managers.[196] In their essence, the unbundling rules provide for greater feedback between shareholders and proxy solicitors, but they do little to shift control of the effectiveness of shareholder voting from managers to shareholders. As illustrated by the *Liberty Broadband* case, management can continue to provide a distorted choice to shareholders by conditioning corporate action on shareholder approval of two or more separately presented resolutions.[197] This outcome raises a couple of questions: Why would the SEC allow a form of bundling by permitting companies to condition action on two or more separate resolutions being approved? Moreover, does the SEC's position affect the deference to be given to any shareholder approval?

The SEC only obliquely suggests why its antibundling provisions authorize managers to condition corporate action regarding one resolution on the stockholders' approval of another resolution; the proposing release explains that this flexibility is guided by the fact that "the legal effect of a matter approved by shareholders generally is a

194. *Id.* § 240.14a-4(b)(1).

195. *See* Regulation of Communications Among Shareholders, 57 Fed. Reg. 48,276, 48,276 (Oct. 22, 1992) (codified at 17 C.F.R. pts. 240, 249), which states:

> By removing unnecessary government interference in discussions among shareholders of corporate performance and other matters of direct interest to all shareholders, these rules should reduce the cost of regulation to both the government and to shareholders. The amendments eliminate unnecessary regulatory obstacles to the exchange of views and opinions by shareholders and others concerning management performance and initiatives presented for a vote of shareholders. . . . The rules also remove unnecessary limitations on shareholders' use of their voting rights, and improve disclosure to shareholders in the context of a solicitation as well as in the reporting of voting results.

196. 17 C.F.R. § 240.14a-4(a)(3) ("Shall identify . . . each separate matter . . . *whether or not related to or conditioned on the approval of other matters* . . . ." (emphasis added)).

197. *See supra* notes 160–67 and accompanying text.

question of state law."[198] The SEC's sensitivity to state law can easily be understood since, at the time it proposed the antibundling rules, it had recently suffered a then-rare rebuke in *Business Roundtable v. SEC*[199] to its rulemaking. Indeed, there was significant pushback against the unbundling rules from corporate and legal commenters based on the notion that the SEC was entering into areas of regulation traditionally governed by state law.[200] Just two years prior to the unbundling regulations, the D.C. Circuit held that the SEC lacked statutory authority to prohibit national security exchanges from listing the stock of companies that violated new rules regulating the creation of dual class shares in *Business Roundtable.* A major part of the court's reasoning was that governance and particularly voting were matters of state law that were not swept within the enabling power of the SEC to regulate proxies.[201] Thus, in crafting the unbundling rules, it is likely that the SEC was being increasingly cautious about exceeding the limits of its authority in light of *Business Roundtable*.

On one hand, the unbundling rules may not go far enough in attempting to right the imbalance of power between managers and owners of publicly held corporations, which is greatly tilted in favor of managers.[202] On the other hand, the corporate and legal commenters who pushed back against the efforts to curtail bundling claimed "there is a "legitimate purpose in providing for a single vote on a group of related matters."[203] In commentary to the final rule published in the Federal Register, the SEC addressed the concern that the unbundling rules could be "misleading" to shareholders who may mistakenly believe they have a choice to accept some but not all of certain grouped proposals.[204] Certainly, this history cannot support bundling of the type embraced by *Corwin*, which included two substantive matters within a single resolution.

198. Regulation of Communications Among Securityholders, 57 Fed. Reg. 29,564, 29,566 (proposed July 2, 1992) (codified at 17 C.F.R. pts. 240, 249).

199. Bus. Roundtable v. SEC, 905 F.2d 406, 408 (D.C. Cir. 1990).

200. *See* Regulation of Communications Among Shareholders, 57 Fed. Reg. at 48,287.

201. *Id.*

202. *See* James D. Cox, Fabrizio Ferri, Colleen Honigsberg & Randall S. Thomas, *Quieting the Shareholders' Voice: Empirical Evidence of Pervasive Bundling in Proxy Solicitations*, 89 S. CAL. L. REV. 1175, 1183–87 (2016) (discussing the strategic advantage management holds over shareholders in the corporate web).

203. Regulation of Communications Among Shareholders, 57 Fed. Reg. at 48,287.

204. *Id.*

D. Lurking Disclosure Considerations

The required scope and detail of disclosure of the possible breaching behavior is undeveloped in *Corwin*. In transactions regulated by the formal proxy rules of the Securities Exchange Act, a good deal of information about the transaction must be disclosed. Even in unregulated transactions, these requirements are something of a template for proxy materials circulated among the shareholders. However, the SEC guides do not address what additional information must be disclosed when there are questions about whether the directors or officers breached their fiduciary obligations in connection with the transaction. For example, where *Revlon* duties are an issue, as they were in *Corwin*, how much must the proxy statement disclose regarding the steps directors took to assure they had pursued the best offer for the firm? On this issue, a fairness opinion is not probative because fairness is a range, not a point, unless the opinion opines the offer submitted is at the very top echelon of the identified fairness range. No doubt such opinions may be acquired, but this merely introduces another concern, namely the independence of the individuals responsible for the disclosures. Because fiduciary duties are owed by the board, the attendant disclosures—and for that matter, the processes followed for the transaction's approval—cannot be viewed as the product of an independent decisionmaker. This point is particularly true in change-of-control situations such as *Corwin*. These concerns place great stress on *Corwin*'s embrace of the curative effects of shareholder approval. And even more stress arises when the bundling itself introduces an unexamined likelihood that the vote is coercive.[205]

The situation in *Corwin* itself is instructive on how problematic disclosure is in such inquiries. KKR Financial Holdings ("KFH") was a limited liability company with its shares listed on the New York Stock Exchange that was acquired by KKR, LP ("KKR"), a limited partnership with its common units also listed on the New York Stock Exchange.[206] Both firms were formed in Delaware.[207] KKR, through its affiliates, provided management services for the conduct of KFH's business pursuant to a management contract that carried a $26,250,000

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205. Note the lack of public enforcement on fiduciary duties by the SEC. *See* Santa Fe Indus. v. Green, 430 U.S. 462, 473–74 (1977) (holding that absent deception, the antifraud provision of the federal securities laws do not apply to breaches of fiduciary duty).

206. Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 306 (Del. 2015).

207. *Id.* at 306 n.3.

termination fee.[208] Even though KKR and various affiliates held substantial ownership interests in KFH, *Corwin* held KKR was not a control person.[209] Consequently, the enhanced scrutiny that Delaware applies to "self-dealing" did not apply.[210]

The parties announced their agreement to the merger on December 16, 2013, and their joint proxy statement was filed with the SEC on March 24, 2014.[211] Thus, three months of trading at the deal-influenced price occurred before any disclosures through the proxy statement were made regarding the KFH directors' conduct. Nowhere in the body of the 235-page proxy statement is there any suggestion, let alone outright statement, that shareholders were asked to approve anything other than the acquisition itself. In other words, the proxy statement neither expressly nor implicitly informed the KFH shareholders they were approving both the transaction and the accompanying conduct of the KFH directors and KKR.[212] To be sure, at several locations within the proxy statement, disclosures were made of the steps the directors took to act independently of KKR and to seek a fair price for the firm.[213] The proxy statement also described in detail the relationships that had long existed between KKR and KFH[214] and disclosed how the KFH directors would benefit, through stock options and phantom stock compensation plans, from the acquisition in ways not shared by the KFH shareholders.[215] Significantly, the proxy statement observed that KFH's independent negotiating committee and its advisors "concluded that [the termination fee and other terms of the agreement] made it highly unlikely that an acquisition of KFH would be of interest to any person other than KKR."[216] However, in repeatedly making these assertions, the proxy statement does not place the termination fee in context; the total value of KFH per the parties' final agreement is slightly in excess of $2.6 billion, meaning that the termination fee is about 1 percent of the transaction's value—a level

208. *Id.* at 306 (making reference to a termination fee; details regarding the fee appear in *In re* KKR Fin. Holdings LLC S'holder Litig., 101 A.3d 980, 986 (Del. Ch. 2014)).

209. *Id.* at 308.

210. *Id.*

211. KKR Fin. Holdings LLC, Definitive Proxy Statement (Schedule 14A) (Mar. 24, 2014) [hereinafter Schedule 14A].

212. *Id.*

213. *Id.* at 38 ("Fairness of the Merger"); *id.* at 91 ("Position of the KKR Participants as to the Fairness of the Merger").

214. *Id.* at 37–38 ("Certain Relationships between KKR and KFH.").

215. *Id.* at 98 ("Interests of Directors and Executive Officers of KFH in the Merger.").

216. *Id.* at 32.

quite low by comparative termination-fee standards.[217] The proxy statement did disclose that KFH's independent committee, through its negotiating stance over a couple of weeks, did improve the price ultimately paid by KKR—the exchange ratio increased in successive offers from 0.46 KKR units to ultimately 0.51 units.[218] Based on the closing price as of the date of the proxy statement, the overall increase was $1.17 per share.[219] Finally, the proxy statement disclosed that fifteen various shareholder suits had been promptly filed and, since their filing, had been consolidated into one federal suit, one Delaware suit, and one California suit.[220] The statement only generally described the nature of the claims.[221] Complaints in the three surviving actions were included in the proxy statement's appendix.[222]

This sketch of KFH's proxy statement shows that KFH shareholders faced a significant challenge in extracting key voting information from a 235-page document. In order to be fully informed, shareholders needed to identify pockets of discrete facts in order to formulate an understandable narrative about how the KFH directors arrived at the ultimate exchange ratio of 0.51 KKR units for each KFH share and to evaluate their acts against the multiple claims of self-dealing relationships and lack of independence. At no point in the body of the proxy statement nor in its attachments was there any summary of the law that applied to the KFH directors or, for that matter, to KKR. Nor was there a single place in the proxy statement that collected the points and counterpoints surrounding the parties' conduct. Furthermore, no guiding principles of law nor crisp presentation of facts with opposing narratives of those facts were present in the disclosure documents. Confounding the choice before the KFH shareholders is the proxy statement's clear language that the merger was occurring at a time when KKR units were trading at a 52-week high

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217. *See id.*, Annex E, at 7. Because Delaware courts regularly accept breakup fees with a much larger relative size, *see* MELVIN ARON EISENBERG & JAMES D. COX, BUSINESS ORGANIZATIONS CASES AND MATERIALS 1291–92 (11th ed. unabr. 2014), the limits so accepted can be seen as not reasonably discouraging third-party suitors. Also placing the termination fee in perspective is that KFH's investment bank garnered $17 million—65 percent of the termination fee—for its fairness opinion and advice in connection with the acquisition. *See* Schedule 14A, *supra* note 211, Annex E, at 2.

218. *See* Schedule 14A, *supra* note 211, at 32–35.

219. The KKR closing price March 20, 2014 was $23.46. *Id.* at 2.

220. *Id.* at 101–03.

221. *Id.*

222. *Id.* annex E, F & G.

and KFH shares were at their 52-week low.[223] It is therefore difficult for voting shareholders to view the transaction other than being the "bird in the hand" so that, given the uncertainty that pervades litigation generally, the rational choice is to forgo litigation by approving the acquisition.[224]

V. A THUMB ON THE SCALE: NEW EMPIRICAL EVIDENCE ON THE EFFECT OF SHIFTS IN THE SHAREHOLDER PROFILE ON VOTING IN M&A DEALS

This Part provides empirical evidence regarding the impact of changes in shareholder ownership around merger announcements on the likelihood of merger completion. In this Part, we find strong empirical evidence that significant share-ownership transfers from long-term to short-term institutional investors following the first announcement that the firm is being acquired. This finding supports the view that the new owners' interests are the option value of the consummated acquisition; as such, the new owners' financial interest is

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223. *Id.* at 41.

224. All of this highlights the importance to the plaintiffs of getting discovery about the statements made in the defendants' disclosures. From the defendants' perspective, one of *Corwin* and *MFW*'s greatest benefits is that they cut off initial discovery into the board's actions related to the transaction, reducing the plaintiff to reliance upon public information, or filing a § 220 action, if they wish to challenge the transaction. However, one does not need to look hard to find pre-*Corwin* or -*MFW* cases where in the absence of discovery, significant managerial misconduct would have gone unrevealed.

In re Del Monte Foods Co. Shareholders Litigation, 25 A.3d 813 (Del. Ch. 2011), is an excellent example. In that case, the board of Del Monte Foods agreed to sell the company to a consortium of private equity firms in what the company's proxy statement portrayed as a reasonably clean deal. *See id.* at 817. However, as the Court put it, "[d]iscovery revealed a deeper problem." *Id.* In fact, the plaintiffs uncovered facts that indicated the company's investment banker, Barclays Capital, had "secretly and selfishly manipulated the sale process to engineer a transaction that would permit Barclays to obtain lucrative buy-side financing fees." *Id.* After substantial litigation, the plaintiffs obtained an $89.4 million judgment. *See In re* Del Monte Foods Co. S'holder Litig., No. 6027-VCL, 2011 WL 6008590 (Del. Ch. Dec. 1, 2011) (order and final judgment); *In re* Del Monte Foods Co. S'holder Litig., No. 6027-VCL, 2011 WL 4802848 (Del. Ch. Oct. 6, 2011) (stipulation and agreement of compromise and settlement).

Numerous other cases have been documented where "early access to discovery material was essential." Joel Edan Friedlander, *Vindicating the Duty of Loyalty: Using Data Points of Successful Stockholder Litigation as a Tool for Reform*, 72 BUS. LAW. 623, 646 (2017). As Friedlander wrote:

> Expedited discovery can uncover e-mails that reveal facts that contradict or are not disclosed in a proxy statement or board minutes. If such facts are uncovered in expedited discovery, and if they are not corrected or disclosed in a supplement to the proxy statement, then defendants cannot take advantage of the legal edifice built around the significance of an informed stockholder vote.

Id. at 645.

served by voting in favor of the acquisition and not voting against the deal as a means to pursue claims of misconduct. Thus, in investigating such ownership changes following deal announcements, we are especially interested in movements of equity stock from long-term owners, such as mutual funds, to short-term owners, such as merger arbitrageurs, and the effect that these movements have on shareholder voting on mergers.

To understand these effects, we must first explain the nature of merger arbitrage. When a merger or takeover deal is announced, large amounts of the target's shares change hands as the original shareholders of the target, now facing deal-completion risk, seek to realize the gains in price of the target shares and avoid future market and deal risks incident to that security.[225] Other investors, called merger arbitrageurs, play a pivotal role in fulfilling this risk-avoidance strategy. The hedge funds and other short-term investors that pursue merger arbitrage strategies, also known as risk arbitrage, buy target companies' stock after proposed mergers are announced and hold it until deal completion in order to earn the spread between the deal price and price after the transaction is announced.[226] This spread reflects the uncertainty that the deal will be successful or that it will close under the original terms.[227] If the deal were to fail, merger arbitrageurs would take a loss given that the price would drop down to preannouncement levels or lower. This incentivizes merger arbitrageurs to be more friendly to target management and more inclined to approve merger transactions.[228] After all, the payoff to the merger arbitrageur's strategy relies on the deal's success.

We are informed by experienced proxy solicitors that investors who are selling their shares to the hedge funds before merger votes are

225. *See* Malcolm Baker & Serkan Savaşoglu, *Limited Arbitrage in Mergers and Acquisitions*, 64 J. FIN. ECON. 91, 92 (2002); Francesca Cornelli & David D. Li, *Risk Arbitrage in Takeovers*, 15 REV. FIN. STUD. 837, 837–38 (2002); Michael Demeter, *Merger (Risk) Arbitrage Strategy*, AIMA CAN. STRATEGY PAPER SERIES, Oct. 2007, at 1, https://docplayer.net/20734417-Merger-risk-arbitrage-strategy.html [https://perma.cc/RWH3-N3WL].

226. Demeter, *supra* note 225, at 1.

227. *See id.* at 1–2; Thomas E. Holber, *Full of Hot Air? Evaluating the* Airgas *Court's Reservations About Shareholders' Short-Term and Long-Term Interests in Takeovers*, 18 FORDHAM J. CORP. & FIN. L. 123, 140 (2012); Aaron Brown, Opinion, *The Reason Merger Arbitrage Funds Aren't Doing Well*, BLOOMBERG (July 11, 2018, 1:00 PM), https://www.bloomberg.com/opinion/articles/2018-07-11/merger-arbitrage-returns-are-suffering [https://perma.cc/TSW5-TJZR].

228. *See* Cornelli & Li, *supra* note 225, at 859; Holber, *supra* note 227, at 140–41; Jim Hsieh & Ralph A. Walkling, *Determinants and Implications of Arbitrage Holdings in Acquisitions*, 77 J. FIN. ECON. 605, 608–09 (2005).

often long-term holders in actively managed funds.[229] Such long-term holders are the parties that are most affected, for better or for worse, by the actions of target management in structuring the proposed transaction and negotiating the deal price. Once the deal is announced, such long-term shareholders can choose to hold-and-vote or to sell. Many actively managed long-term holders generally prefer to sell their shares and capture the deal premium rather than to lobby against the deal, even if they are dissatisfied with the actions of target management. Investing, or remaining invested, in deal stocks involves analyzing a significant number of variables that, while unfamiliar to a typical long-term, active investor, are within the expertise of merger arbitrageurs.

For our purposes, we wish to observe the frequency of such ownership changes and assess the extent to which any observed shift in stock ownership causes a change in the likelihood of the completion of the merger. Logically, if a large block of stock moves out of the hands of long-term investors and into the hands of short-term merger arbitrageurs, then the likelihood of the merger being approved by shareholders increases, even if the deal was the result of careless or unfaithful target management actions. This is because merger arbitrageurs will make money on deals that close and will lose money on deals that do not. In this Part, we empirically study what kind of deals attract merger arbitrageurs and what their effects are on merger outcomes.

Specifically, we first measure the increase in ownership by short-term investors, such as hedge funds and other arbitrageurs, from the quarter before the deal's announcement to the quarter after that announcement. In line with merger arbitrage strategies, our empirical results suggest short-term investors buy into target companies once an announcement is made, replacing other medium- and long-term investors. Second, we show that the likelihood of deal completion is increased by this observed ownership change.

A. Methodology and Data

Our analysis relies on identifying short-term institutional investors that engage in merger arbitrage, or similar short-term strategies, as well as measuring the change in equity ownership during merger deals. Our methodology consists of an empirically based characterization of

229. This paragraph is based on our confidential conversations with experienced proxy solicitors.

investors based on their portfolio horizons. That is, short-term investors are defined as those institutions with high portfolio turnover, while long-term investors are those with low turnover.[230]

1. *Institutional Investor Turnover*. The focus of our analysis is on institutional investors' ownership. In general, an institutional investment manager is an entity that invests in securities for its own account or an entity that exercises investment discretion over the account of another.[231] Institutional investment managers can include banks, insurance companies, pension funds, investment managers, hedge funds, and corporations, among others.[232] Using data on equity holdings of institutional investors from public filings with the SEC required by § 13(f) of the 1934 Securities Exchange Act, we calculate institutional investors' annualized portfolio turnover.[233] Portfolio turnover is compounded from the quarterly turnover rates, which are calculated as the lesser of purchases and sales divided by the investor's portfolio size. Hence, it measures the proportion of the portfolio that is changed within a year, and the inverse can be used as a proxy for investor horizon.

Table 1 shows sample statistics for portfolio turnover and equity holdings by institutional investor type. Columns 1 and 2 show the mean portfolio turnover and standard deviation to describe, on average, how often investors change their portfolios and how varied the turnover might be within an investor class, respectively. As expected, hedge funds have the highest turnover—the shortest time horizon for holding

230. Some scholars have related empirical definitions focusing on merger arbitrageurs rather than a larger set of short-term investors. *See, e.g.*, Baker & Savaşoglu, *supra* note 225, at 108; Jan Jindra & Ralph A. Walkling, *Speculation Spreads and the Market Pricing of Proposed Acquisitions*, 10 J. CORP. FIN. 495, 497 (2004). An alternative characterization is to use a *de jure* classification of institutional investor type. Indeed, as we will show, hedge funds tend to have the shortest investment horizons. However, simply relying on type classifications can be problematic, since some asset management firms, such as GAMCO, might employ merger arbitrage or other active strategies in their portfolio management, while others take a more passive approach. GAMCO Investors, formerly known as Gabelli Asset Management Company, is a well-known investment fund that engages in a broad variety of investment strategies, including merger arbitrage. *See* GABELLI FUNDS, https://www.gabelli.com [https://perma.cc/M2PP-2ZMT].

231. *Form 13F-Reports Filed by Institutional Investment Managers*, U.S. SEC. & EXCHANGE COMMISSION (Feb. 9, 2015), https://www.sec.gov/fast-answers/answers-form13fhtm.html [https://perma.cc/9QK6-DQR4].

232. We rely on Vikas Agarwal, Vyacheslav Fos & Wei Jiang, *Inferring Reporting-Related Biases in Hedge Fund Databases from Hedge Fund Equity Holdings*, 59 MGMT. SCI. 1271 (2013), for a classification of institutional investors into the various types listed in *infra* Table 1.

233. For a description of the method utilized to calculate institutional investors' annualized portfolio turnover, see Agarwal, Fos & Jiang, *supra* note 232, at 1277 & n.14.

stock—while traditional buy-and-hold investors[234] have the lowest turnover. Asset management firms and mutual funds have average holding horizons but relatively high variance due to the large fund heterogeneity among these institutional investors. Column 3 shows the largest institutional investors by total assets under management ("AUM") in equities. The two largest types are mutual funds and asset managers, which have a mixture of passive and active portfolios and investments. Among the top five largest investor classes are hedge funds, which account for 10 percent of total AUM. Hedge funds also rank second amongst the most numerous investor categories, after asset management firms, as shown in Column 4. Finally, Column 5 shows that on average, hedge funds have one of the lowest number of equity positions per investor, which means they are amongst the least diversified types of institutional investors. This observation is consistent with the view that most hedge funds specialize in specific strategies or segments of the equity market so they tend to keep concentrated positions. On the other hand, pension funds and mutual funds rank as the most diversified investors.

Table 1: Portfolio Turnover by Investor Type[235]

This Table reports statistics on annualized portfolio turnover rates by investor type. Column 1 and 2 report mean and standard deviation of the portfolio turnover statistic. Column 3 shows the total AUM in equities of each investor type. Column 4 shows the average number of institutional investors for each investor type, and Column 5 reports the number of equity positions or investments per investor. The sample is from 2000 to 2015.

	Turnover		Total AUM	Avg. # of	Avg. # of
	Mean	SD	($bn)	Investors	Positions
Hedge Funds	1.64	1.35	1,009.24	648.25	118.09
IB and Brokerage	0.74	0.73	373.94	52.81	552.64
Asset Management	0.62	0.69	2,574.61	1,266.57	153.19
Mutual Funds	0.49	0.38	2,777.46	95.31	504.55
Fin. Arms of Corps	0.47	0.45	42.61	12.69	195.24
Other	0.43	0.69	56.32	42.87	149.93
Insurance	0.42	0.26	467.97	71.43	386.31

234. Buy-and-hold refers to the investment strategy of buying stocks and holding them for a long time with relatively little trading. In general, endowments, pension funds, insurance companies and passive asset managers or mutual funds follow this strategy to some degree.

235. Turnover calculation methodology and institutional investor classification are as described in Agarwal, Fos & Jiang, *supra* note 232.

Banks and Trusts	0.31	0.19	1,987.23	206.25	435.62
Endowments	0.29	0.31	36.91	21.12	111.7
Pension Funds	0.26	0.24	321.44	31.19	779.02

2. *Data on Merger Deals.* Our data on merger announcements and characteristics are from the Securities Data Company ("SDC") database.[236] We limited our data to merger deals where the acquirer must garner a majority support from the target shareholders to acquire 100 percent of the shares in the target firm. Therefore, we only use mergers and acquisitions where the target firm is incorporated in the United States, where the acquirer's existing stake does not exceed 50 percent of the target firm and where data on all deal characteristics is available. We match the sample with the Center for Research in Securities Prices ("CRSP")[237] stock-price data and COMPUSTAT[238] obtained from firms' 10Qs and other quarterly financial filings. Finally, we limit the sample to firms with more than fifty institutional shareholders and deals with a value greater than $10 million to avoid large changes in ownership from a shift in a small number of investors.[239] In total, the full sample includes 852 merger deals from 2000 to 2015.

3. *Summary Statistics*. Table 2 presents summary statistics of firm characteristics for targeted firms in the sample. Firm characteristics are lagged one-quarter to avoid endogeneity due to the merger announcement and merger arbitrageur activity.[240] We first include

236. *SDC Platinum Financial Securities Data*, REFINITIV SEC. DATA CO. (SDC), https://www.refinitiv.com/en/products/sdc-platinum-financial-securities [https://perma.cc/ADC8-V54E].

237. CTR. FOR RES. SEC. PRICES (CRSP), http://www.crsp.com [https://perma.cc/4QRG-EL5H].

238. *CompuStat® Data from S&P Global Market Intelligence*, S&P GLOBAL (Oct. 2017), https://www.spglobal.com/marketintelligence/en/documents/compustat-brochure_digital.pdf [https://perma.cc/796L-7DKW].

239. Without a threshold, there are some small firms that have large changes in ownership that are not related to merger arbitrage. Results are robust to other thresholds, such as $50 million or $100 million.

240. In very small target firms with few institutional shareholders, small and possibly unrelated changes in institutional holdings can lead to large changes in short-term ownership that do not reflect merger arbitrage activity. This filter improves the performance of our measure of merger arbitrage but does not qualitatively change results.

market capitalization ("Mkt Value")[241] as our measure of size and book-to-market price ("B/M")[242] as a measure of the growth opportunities of the firm. Both these variables might be correlated with changes in shareholder composition because they correlate with growth opportunities and likely determine the merger or takeover interest in a target firm. The variable "Leverage," representing the indebtedness of the target firm, is defined as the ratio of debt-to-book equity. "LnVol" is the logarithm of trading volume as a share of outstanding shares and measures the liquidity of the target firm's stock.[243] Liquidity can help explain the cross-sectional variation in merger arbitrageur activity because informed investors can more easily hide their trades.[244] We add the Herfindahl-Hirschman Index ("HHI"), which proxies for the degree of industry concentration and therefore is likely to increase regulatory and antitrust risk.[245] This is likely to be correlated with the risk of deal noncompletion for strategic mergers.

We also include "Revenue Growth,"[246] which measures past firm performance reflected in the company's income statement. However, this does not necessarily reflect future performance since it is not a forward-looking measure. Therefore, we add "Stk Ret," the past twelve-month stock return relative to the firm's industry, which represents the stockholders' forward-looking expectations for the firms relative to the industry average. The last variable shown in Table 2 is the percentage of shares owned by institutional investors relative

241. Market value, or market capitalization, is the total value of shares outstanding as priced in the market. *See* Denys Glushkov, *Market-to-Book (M/B) Ratio*, WHARTON U. PA. (Sept. 2011), https://wrds-www.wharton.upenn.edu/pages/support/applications/risk-and-valuation-measures/market-book-mb-ratio [https://perma.cc/H8KF-JEJF].

242. Book-to-market is the book value of equity as represented in the balance sheet divided by the market value of outstanding equity. A large book-to-market ratio suggests a company has limited growth opportunities, while a smaller ratio suggests the opposite. *See id.*

243. Volume traded is the total quantity of shares traded on a given day. Logarithm of volume as a share of outstanding shares is a measure of the percentage of trades relative to the number of shares available in the market. Pagano discusses the links between traded volume and asset liquidity. *See generally* Marco Pagano, *Trading Volume and Asset Liquidity*, 104 Q.J. ECON. 255 (1989).

244. Cornelli & Li, *supra* note 225, at 839, 858.

245. The Herfindahl-Hirschman Index ("HHI") is a measure of industry concentration. It is calculated by taking the sum of the market shares squared for all firms in an industry. Stephen A. Rhoades, *The Herfindahl-Hirschman Index*, 79 FED. RES. BULL. 188, 188–89 (1993).

246. Revenue growth is an important determinant of merger activity since it is likely correlated with valuation but is a function of firm history. Alex Edmans, Itay Goldstein & Wei Jiang, *The Real Effects of Financial Markets: The Impact of Prices on Takeovers*, 67 J. FIN. 933, 946–48 (2012).

to shares outstanding.[247] The remaining shares are owned by retail investors. On average, 66 percent of the shares in target firms are owned by institutional investors. Not only do institutional investors hold a large share of issued stocks, but they also tend to vote more frequently than retail investors.[248] This means that changes in ownership among institutional investors will likely matter more for corporate governance issues.

Table 2: Summary Statistics

This Table reports summary statistics on the main firm-level variables. Data is obtained from COMPUSTAT and CRSP. The sample is from 2000 to 2015.

Variables			Percentiles				
	Mean	SD	5%	25%	50%	75%	95%
Mkt Value ($M)	1,614.42	5,228.71	12.32	61.59	229.15	1,009.21	6853.64
B/M	0.72	0.69	0.09	0.34	0.57	0.9	1.93
Leverage	3.52	4.91	0.15	0.51	1.29	4.28	13.45
Ln(Vol)	-0.31	1.24	-2.48	-1.16	-0.2	0.6	1.56
HHI	0.08	0.08	0.02	0.04	0.05	0.09	0.21
Rev Growth	0.12	0.48	-0.33	-0.05	0.05	0.18	0.67
Stk Ret	-0.04	1.04	-0.8	-0.35	-0.11	0.14	0.71
Inst. Ownership	0.66	0.20	0.31	0.53	0.67	0.79	0.96

Although the existence of merger arbitrageurs is well known, our first step is to quantify the target firm's shareholder composition changes around takeover announcements. Table 3 shows summary statistics for the change in institutional investor composition as a share of all institutional investors for target firms. Panel A shows the change from the quarter preceding the merger announcement, "*Q-1*," to the first quarter ending after the announcement, "*Q*." This measure

247. The ratio of institutional investors' dollar holdings to market value represents the amount of stock held by institutional investors versus retail investors. *See id.* at 950.

248. *See* Alon Brav, Wei Jiang, Tao Li & James Pinnington, *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* 2 (ECGI Working Paper Series in Fin., Working Paper No. 601/2019, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3101473 [https://perma.cc/Q3X9-QNZ6] ("The general apathy of retail investors in engaging in voting matters implies that it is crucial that dissidents obtain the support of a majority of the institutional shareholders of the targeted firms."); ProxyPulse, *2018 Mini-Season Wrap-Up and 2019 Trends*, BROADRIDGE FIN. SOLUTIONS (2019), https://www.broadridge.com/_assets/pdf/broadridge-proxy-pulse-preview-2019.pdf [https://perma.cc/5QPC-WML7].

captures the change in shareholders for a relatively small window around the merger announcement.[249] Using our measure of portfolio turnover, we classify investors as short-term (turnover greater than 1), medium-term (turnover between 0.33 and 1), or long-term (less than 0.33).[250] The key takeaway from Panel A is that short-term ownership increases on average by a noticeable 11.22 percentage points (of total institutional ownership) in the immediate quarter. Moreover, this change in ownership does not anticipate but rather takes place only after the announcement reflecting risk arbitrageurs in action.[251] This evidence points to a large participation of short-term, merger arbitrageur investors that buy shares after mergers are announced but not before, as they do not try to anticipate mergers. Panel A also shows that hedge funds tend to be short-term investors that engage in these arbitrage strategies, while asset managers and mutual funds, which are medium- or longer-term investors, tend to reduce their positions. Interestingly, the longest-term investors, such as pension funds or endowments, do not seem to alter their ownership relative to other institutional investors. This means that these very few long-term investors are likely to remain as shareholders and vote on the merger.

Panel B in Table 3 shows the change in ownership from the quarter preceding the merger announcement, "*Q-1*," to the last quarter in the merger "*Q+T*," where "T" is the duration of the merger from announcement to conclusion. In this larger event window, the increase in short-term investor ownership is 13.19 percentage points, which is slightly larger than in Panel A. This means that merger arbitrageurs maintain, and even increase, their positions through the merger-approval process. The fact that the merger-end change tends to be larger than the one-quarter change speaks to slow-moving capital in some investors as it may take them time to move between positions and choose where to invest. Nevertheless, most merger arbitrage investors likely buy shares soon after the announcement. There is evidence (untabulated) of this speediness in the significant increase in short-

249. This is the tightest window we can use since 13(f) ownership data is reported on a quarterly basis. *See Form 13F-Reports Filed by Institutional Investment Managers*, *supra* note 231.

250. The inverse of portfolio turnover is a proxy for the portfolio horizon, so short-term investors have investment horizons below one year, medium-term investors have horizons between one and three years, and finally, long-term investors have horizons greater than three years.

251. Our data suggests that the change in ownership does not happen before the merger is announced because there is no change in ownership in the quarter preceding the announcement, while it is just as large as in Table 3 when the merger is announced only a few days after the *Q-1* quarter-end.

term ownership in the subsample of mergers announced a day before *Q,* the immediate quarter-end when investors report their equity holdings. This indicates that our measure of change in short-term ownership does in fact identify merger arbitrage activity.

B. Determinants of Arbitrageur Participation

Although on average there is a large change in short-term ownership before voting, some deals seem to attract more arbitrageurs than others. Are arbitrageurs mainly present in reasonably riskless and transparent deals that are unlikely to be challenged? If so, changes in ownership may not be as problematic under *Corwin*, since these deals are unlikely to face further equity-holder damage claims. However, the *Corwin* decision would be problematic if arbitrageurs target risky deals as well. To address this question we next explore the determinants for merger arbitrage activity.

Table 3: Change in Shareholder Composition

This Table reports the change in institutional investor composition around merger announcements. Shareholder composition is measured as a percentage (%) of all institutional investors. Panel A compares ownership measures from 13(f) filings in the preceding quarter *Q-1* to those in the quarter *Q* immediately following the announcement. Panel B compares ownership in the preceding quarter *Q-1* to those at the end of the merger *Q+T*, whether completed or withdrawn. We classify investors as short-term if turnover is greater than 1, medium-term if between 0.33 and 1, and long-term if lower than 0.33. Final sample contains 852 mergers from 2000 to 2015 with at least 50 institutional investors.

	Change in Shareholder Composition (% of Institutional Investor Ownership)					
Category	Mean	SD	Min	0.25	0.75	Max
Panel A: One Quarter Change: Q-1 to Q						
Short-Term	11.22	9.95	-14.23	4.15	17.51	50.44
Med.-Term	-8.08	10.10	-45.66	-13.80	-1.69	31.92
Long-Term	-3.14	8.06	-37.57	-6.98	1.81	30.17
Hedge Funds	9.82	10.17	-33.72	2.90	15.79	58.31
IB and Brokerage	1.14	3.22	-26.48	-0.26	2.39	25.38
Asset Management	-5.97	8.17	-50.73	-10.10	-0.81	17.50
Mutual Funds	-4.19	6.78	-34.29	-7.68	-0.01	31.95
Fin. Arms of Corps	-0.02	0.26	-4.78	-0.01	0.00	3.35

Other	0.15	0.78	-5.27	-0.01	0.16	10.80
Insurance Companies	-0.79	2.07	-16.36	-1.16	0.09	10.16
Banks and Trusts	-0.59	4.45	-20.01	-2.60	1.78	28.58
Endowments	0.22	1.24	-2.70	0.00	0.07	26.38
Pension Funds	0.25	1.39	-12.07	-0.36	0.79	6.40
Panel B: Merger End Change: Q-1 to Q+T						
Short-Term	13.50	11.16	-17.32	5.24	20.61	50.44
Med.-Term	-9.63	11.49	-56.17	-16.86	-2.22	23.71
Long-Term	-3.87	9.13	-51.38	-8.69	1.72	30.29
Hedge Funds	11.96	11.21	-33.93	4.33	18.30	58.31
IB and Brokerage	1.41	3.71	-26.48	-0.28	2.77	32.38
Asset Management	-7.20	8.86	-58.90	-11.56	-1.64	18.07
Mutual Funds	-5.03	7.71	-39.05	-9.47	-0.07	29.89
Fin. Arms of Corps	-0.06	0.43	-4.53	-0.04	0.01	1.38
Other	0.15	0.85	-6.39	-0.03	0.20	10.80
Insurance Companies	-1.01	2.30	-16.36	-1.50	0.06	10.16
Banks and Trusts	-0.70	5.15	-29.84	-2.96	1.92	28.58
Endowments	0.16	0.68	-1.95	0.00	0.12	7.07
Pension Funds	0.18	1.47	-12.09	-0.49	0.78	5.70

In general terms, a merger arbitrageur's objective is to capture the risk premium—the spread between the bid price and the postannouncement market stock price—while minimizing the risk of a costly failing merger. Similar to other insurance markets, the risk that the merger will not succeed is reflected in the spread—the difference between the market price at which the security is purchased and the ultimate payment received when the deal is consummated—which is the compensation paid to arbitrageurs for taking on the noncompletion risk. As a classic risk–return proposition, merger arbitrageurs may avoid deals with certain characteristics as the risks associated with the expected payout at a deal's conclusions are too great for the rewards of undertaking the arbitrage transaction.[252] Table 4 sets forth several variables that impact the arbitrageurs' assessment of the risks posed by merger transactions

Table 4: Short-Term Ownership Changes and Deal Characteristics

This Table reports the change in short-term ownership and spread conditioning on several merger characteristics. Spread is calculated as the percentage increase in the bid price over the target's stock price one day after the announcement. "*Duration*" is the number of quarters the merger process takes from announcement to conclusion; "*Outcome*" is either a successful merger with shareholder approval or a withdrawn proposal; "*Consideration*" is separated into cash, shares, and other types; Management Buyout ("*MBO*") are mergers where management participated as the acquiring party; "*Competing Bids*" represents mergers with competing bids; "*Attitude*" describes whether the merger is hostile or friendly; finally, "*Appraisal*" indicates if an appraisal was petitioned. Both the One-Quarter change and End-Date change are with respect to the pre-announcement quarter. "*Diff*" columns show the difference in coefficients along with the statistical significance of a *t*-test. Significance at the 10%, 5%, and 1% levels are indicated by *, **, ***, respectively.

Category	No. Deals	in ST Ownership (% of Institutional Investor Ownership)				Spread (%)	
		One-Quarter		End-Date			
		Change	*Diff*	Change	*Diff*	Change	*Diff*
Outcome							
Completed	773	11.64	—	13.86	—	6.14	—
Withdrawn	79	7.12	-5.52***	9.97	-3.88***	10.87	4.73***
Duration							
1	388	12.55	—	12.55	—	7.07	—
2	303	9.59	-2.05***	13.57	1.02	5.80	-1.26
3 or more	161	9.37	-3.17***	15.63	-3.09***	6.85	-0.21
Consideration							
Cash	431	12.6	—	14.95	—	4.73	—
Shares	176	7.39	-4.83***	9.03	-5.91***	11.42	6.69***
Hybrid / Other	245	11.53	-0.44	14.16	-0.78	6.36	1.63*
Self-Dealing Transaction							
No	668	11.59	—	13.96	—	7.01	—
Yes	184	9.88	-1.71**	11.84	-2.12**	4.69	-2.4**

252. John Paulson, *The "Risk" in Risk Arbitrage*, *in* MANAGING HEDGE FUND RISK: FROM THE SEAT OF THE PRACTITIONER – VIEWS FROM INVESTORS, COUNTERPARTIES, HEDGE FUNDS AND CONSULTANTS 189, 190–98 (Virginia Reynolds Parker ed., 2000).

<u>*Management Buyout*</u>							
No	834	11.32	—	13.52	—	6.93	—
Yes	18	6.64	-4.68**	12.31	-1.21	7.75	0.823
<u>*Competing Bids*</u>							
No	793	11.17	—	13.38	—	6.18	—
Yes	59	11.93	0.66	15.09	1.71	11.96	5.77***
<u>*Attitude*</u>							
Friendly	849	11.23	—	13.49	—	6.50	—
Hostile	3	7.62	-3.61	14.17	0.68	29.84	23.34***
<u>*Appraisal*</u>							
No	835	11.23	—	13.50	—	6.66	—
Yes	17	10.62	-0.61	13.31	-0.19	3.01	-3.64

Table 4 shows related mean statistics for short-term ownership changes conditioned on various deal characteristics and outcomes. The last column of the table also shows the average bid spread, defined as the percentage increase of the bid price from market price before the announcement. We see that overall the average percentage of deal completion is 91 percent in our sample. Several other very interesting results merit discussion.

First, on average, the change in short-term ownership is greater in successful deals—11.64 percent for one quarter; 13.69 percent for end-date—than in withdrawn ones—7.12 percent for one quarter; 9.97 percent for end-date. This speaks to the ability of hedge funds to distinguish between deals as well as to the possible impact that arbitrageurs have on merger outcomes. Additionally, the spread is significantly lower for successful deals—6.14 percent for successful deals versus 10.87 percent for unsuccessful ones—implying that riskier deals are in fact priced as such. Secondly, we see that longer deals tend to attract fewer arbitrageurs right after the deal is announced as shown by the one-quarter change—12.55 percent for short deals against 9.37 percent for longer ones—but short-term investors significantly increase their ownership as time goes by or as the merger nears completion, increasing from 9.37 percent in the one-quarter change to 15.63 percent by end-date.

Other conditioning variables are deal characteristics. Both self-dealing transactions[253] and management buyouts are known to pose

253. A self-dealing transaction is defined as a deal where the acquirer has a toehold greater than 5 percent in the target or the company is to be taken private.

higher risks of management wrongdoing,[254] and these seem to have smaller increases in short-term investors. These results are consistent with the idea that merger arbitrageurs are not willing to take on this type of high risk, especially given the lack of reward in higher spreads. The fact that the short-term investors identified are reluctant to hold shares of firms in self-dealing mergers with low spreads is further indication that they are merger arbitrageurs, and not appraisal arbitrageurs, because the latter group seeks to make profits by litigating over possible conflicts of interest while the former seeks to profit from the price spread.

The type of consideration received upon a deal's conclusion is another important determinant of arbitrage activity. Arbitrageurs face an additional risk in noncash mergers because stock lacks a fixed consideration value, and the merger arbitrageurs cannot ensure a positive spread profit between the postannouncement buy-in date and the time of completion.[255] If the stock market were to perform poorly during the merger process, they could lose money even if the merger was successful.[256] Table 4 reflects that this risk implies a larger increase of short-term ownership as well as lower spread for cash deals. Finally, Table 4 also presents statistics on deals with multiple competing bids and merger attitude—that is, whether the deal is hostile or friendly. Competing bids can result in larger bid premia and bid improvements.

Merger arbitrage is not the only strategy hedge funds can employ during mergers. Some hedge funds have recently engaged in appraisal arbitrage, whereby they target mergers with possible conflicts of interest to petition an appraisal and possibly litigate.[257] Clearly, an appraisal-arbitrage strategy would have significantly different effects on corporate outcomes since their strategy consists of voting against the merger. The last conditioning variable in Table 4 is whether a fund petitioned for an appraisal of the fair value of the shares. As Table 4 shows, there are relatively few appraisal-arbitrage cases in our sample—twenty-eight, to be exact—and appraisal does not appear to be correlated with a statistically significant larger increase in short-term ownership. This implies that the changes in short-term ownership

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254. Wei Jiang, Tao Li, Danqing Mei & Randall Thomas, *Appraisal: Shareholder Remedy or Litigation Arbitrage?*, 59 J.L. & ECON. 697, 699 & n.2 (2016).

255. Paulson, *supra* note 252, at 195.

256. For this reason, in stock deals, it is common for arbitrageurs to also short the acquirer's stock and lock in a spread. However, this is not a possible strategy for every merger arbitrageur and poses other risks. *See id.* at 191.

257. Jiang et al., *supra* note 254, at 698.

identified in our sample are more consistent with merger arbitrage rather than with appraisal arbitrage. In fact, that short-term investors are reluctant to hold shares of firms in self-dealing mergers with low spreads is an indication that they are merger arbitrageurs, and not appraisal arbitrageurs, because the latter group seeks to make profits by litigating over possible conflicts of interest while the former seeks to profit from the price spread.

Although the mean statistics in Table 4 speak to several different results, they do not consider possible correlations between firm, deal characteristics, and short-term ownership changes. To study determinants for the change in ownership around merger announcement and address this concern, we need to regress ownership changes on these variables. Through use of regression techniques, we seek to understand in which cases we should expect higher arbitrageur participation, as this would highlight when other investors choose to sell-out and not to vote on the merger. On the one hand, if merger arbitrageurs offer insurance against possible deal breakdowns and large downfalls in prices, then we should expect larger changes in ownership around risky deals and those with higher bid premia over previous market prices. On the other hand, arbitrageurs may also avoid deals with poor prospects if they are unlikely to succeed and will shy away from having to participate as activists engaging in manager-monitoring behavior.

Table 5 shows estimates for regressions of the change in institutional ownership on a variety of independent variables, including the target firm's characteristics and deal characteristics. The dependent variable in the first three columns is the one-quarter change in ownership, while in the last three columns it is the change to the last quarter of the merger.[258] Among the firm characteristics, market capitalization is an important determinant in the first quarter of the deal possibly because it is easier to coordinate strategies with other short-term investors at larger firms.

Deal characteristics appear to be important determinants of merger arbitrage activity. Our results suggest that self-dealing transactions, and to a lesser extent management buy-outs, discourage short-term investors from holding target stocks during mergers. This result is somewhat puzzling, given that these types of mergers involve a higher risk of failure, but the greater risk is not matched by a larger

258. Additionally, all regressions include year fixed effects to account for varying market conditions and other time effects.

spread as shown in Table 4. The type of consideration to effect the merger is another important determinant of arbitrage activity. Cash deals are associated with increases in short-term ownership relative to stock and hybrid deals.

Finally, the offer premium, defined as the spread between the offered merger price and the pre-announcement market price, is also an important determinant. An increase of one percentage point in the offer premium is associated with a five-basis-point increase in short-term investor ownership.

Table 5: Determinants of Change in Stock Ownership

This Table reports estimates from regressing changes in ownership composition as a percentage of institutional investors on firm and deal characteristics. The dependent variables in the first three columns are one-quarter changes ("*Q-1* to *Q1*") for short-term ("ST"), medium-term ("MT") and long-term ("LT") investors, respectively. In the last three columns, it is merger-end changes ("*Q-1* to *Q+T*") for short-term ("ST"), medium-term ("MT") and long-term ("LT") investors. The target firm characteristics are market capitalization ("MV"), book-to-market ("B/M"), leverage ratio, dividend yield, revenue growth, past year stock market growth relative to industry average, the logarithm of traded volume, and the Herfindahl-Hirschman Index ("HHI").

Dep. Variable	in Ownership (% of Institutional Investors)					
	Q-1 to *Q*			*Q*-1 to *End of Merger*		
	ST	MT	LT	ST	MT	LT
MV	-0.752***	0.747***	0.00563	-0.304	0.676**	-0.372
	(-2.94)	(2.88)	(0.02)	(-1.01)	(2.22)	(-1.45)
B/M	-2.139**	1.444	0.695	-2.261**	1.849*	0.412
	(-2.46)	(1.62)	(0.88)	(-2.47)	(1.85)	(0.50)
Leverage	0.0493	0.0414	-0.0907	0.133	0.0294	-0.163*
	(0.59)	(0.47)	(-1.17)	(1.56)	(0.30)	(-1.89)
Div. Yield	-8.336**	3.803	4.533	-11.15**	7.073	4.075
	(-2.10)	(0.87)	(1.08)	(-2.58)	(1.40)	(1.03)
Rev. Growth	-0.0255	-0.0485	0.0740	-0.196	0.128	0.0675
	(-0.04)	(-0.06)	(0.15)	(-0.24)	(0.13)	(0.13)
Past Stk Return	0.277	0.278	-0.555***	0.323	0.105	-0.428**
	(1.05)	(1.26)	(-3.25)	(0.96)	(0.36)	(-2.04)
Volume	0.686	-2.009***	1.324***	0.556	-2.103***	1.547***
	(1.54)	(-4.66)	(3.54)	(1.13)	(-4.18)	(3.68)
HHI	1.162	-0.418	-0.744	-0.183	-1.009	1.191

	(0.28)	(-0.10)	(-0.23)	(-0.04)	(-0.21)	(0.30)
Self-Dealing	-2.666***	3.127***	-0.461	-3.533***	3.406***	0.127
	(-2.81)	(3.28)	(-0.63)	(-3.44)	(3.28)	(0.16)
MBO	-3.690*	3.048	0.642	0.511	-0.381	-0.130
	(-1.80)	(1.56)	(0.48)	(0.21)	(-0.16)	(-0.08)
Hostile	-7.007**	3.744	3.263*	-3.612	2.038	1.574
	(-2.27)	(1.27)	(1.94)	(-0.57)	(0.45)	(0.61)
Cash	2.211***	-2.485***	0.274	2.782***	-2.877***	0.0943
	(2.72)	(-3.04)	(0.43)	(3.01)	(-3.11)	(0.13)
Competing Bids	1.710	-1.158	-0.552	2.937*	-1.995	-0.942
	(1.21)	(-0.87)	(-0.52)	(1.73)	(-1.18)	(-0.79)
Bid Premium	5.374***	-3.412**	-1.962	5.657***	-2.756	-2.901**
	(3.43)	(-2.27)	(-1.60)	(3.20)	(-1.52)	(-2.09)
Constant	9.201***	-9.261***	0.0601	8.296***	-11.79***	3.499
	(3.76)	(-3.46)	(0.03)	(2.77)	(-3.60)	(1.42)
R-squared	0.130	0.132	0.136	0.107	0.124	0.142
Observations	852	852	852	852	852	852

C. *Effects on Merger Outcomes*

Large ownership shifts pose a problem under *Corwin* because, ultimately, voting does not reflect the same deal-approval preference to that of the original shareholders. Since merger arbitrageurs can be expected to vote in favor of deals in light of their substantial investment being riveted to the value of the end-of-deal consideration, the large shift in ownership we observe can be decisive in determining the outcome of a deal. Moreover, since high share turnover is observable and signals merger arbitrage activity, other investors may feel this thumb on the scale and decide to support the deal rather than vote against it.

What is the projected effect of these ownership shifts on the likelihood of merger completion? In Table 6, we set forth data that enables us to assess the impact of changes in institutional ownership during M&A events and merger outcomes. Specifically, we present evidence that merger arbitrageur activity is associated with a higher likelihood for merger success in deals where shareholder approval is decisive.

Table 6: Merger Outcomes

This Table reports estimates of a probit model for merger success. In both regressions, the dependent variable is 1 if the merger was successful and 0 otherwise. The variable of interest in the first regression is the change in short-term ownership (“ ST”). The second regression uses a Top 20% to indicate if ST is in the top quintile, and a Bottom 20% dummy to indicate if ST is in the bottom quintile. The “dPr/dX” columns show the marginal effects on merger success probability of a unit change (or 100 basis points) in each regressor.

Dep. Variable:	Success=1		Success=1	
	Probit	dPr/dX	Probit	dPr/dX
ST (%)	0.0268***	0.30%		
	(3.61)			
Top 20%			0.648**	2.48%
			(2.51)	
Bottom 20%			-0.0794	-5.32%
			(-0.50)	
Spread (%)	-0.870**	-0.11%	-0.820**	-0.09%
	(-2.45)		(-2.28)	
MV	0.0912*	1.02%	0.0916*	1.03%
	(1.74)		(1.74)	
B/M	0.0713	0.80%	0.0813	0.92%
	(0.39)		(0.43)	
Leverage	-0.00850	-0.10%	-0.00818	-0.09%
	(-0.51)		(-0.48)	
Div. Yield	-0.632	-7.10%	-0.809	-9.13%
	(-0.79)		(-0.98)	
Rev. Growth	-0.323***	-3.63%	-0.326***	-3.68%
	(-2.76)		(-2.84)	
Past Stk Return	0.00880	0.10%	0.00826	0.09%
	(0.20)		(0.19)	
Volume	-0.0671	-0.75%	-0.0880	-0.99%
	(-0.73)		(-0.94)	
HHI	-1.039	-11.67%	-1.109	-12.52%
	(-1.56)		(-1.63)	

Self-Dealing	-0.424**	-4.76%	-0.433**	-4.89%
	(-2.11)		(-2.14)	
MBO	-0.210	-2.36%	-0.305	-3.44%
	(-0.52)		(-0.75)	
Hostile	-0.793	-8.91%	-0.954	-10.76%
	(-1.26)		(-1.50)	
Cash	0.176	1.98%	0.188	2.12%
	(1.04)		(1.09)	
Competing Bids	-1.714***	-19.25%	-1.721***	-19.42%
	(-7.96)		(-7.88)	
Constant	1.078**		1.182**	
	(2.27)		(2.46)	
R-squared	0.258		0.254	
Observations	839		839	

Unlike the sample used in previous tables, this analysis excludes mergers that failed on regulatory grounds. Merger deals are usually subject to regulatory approval intended to prevent anticompetitive transactions, but such reviews can lead to deal failures regardless of shareholder composition or investor support.[259] In fact, out of seventy-nine failures in our original sample, we identify ten regulatory failures that correspond with an increase in short-term ownership that was 6.7 percentage points lower than in other failures. It would be imprudent to claim that these ten deals failed because of less arbitrage activity.

Table 6 shows estimates of a probit model of merger success likelihood, highlighting the importance of shareholder changes.[260] The main variable of interest is the one-quarter change in short-term ownership ("*ST*"), which captures the amount of merger arbitrage participation, while the remaining variables are covariates that can also affect success likelihood. In the first regression, the coefficient on *ST* shows evidence of the importance of merger arbitrage and the second column presents the marginal effects ("dPr/dx"), which allows us to

259. Data on regulatory failures were provided by Morgan Ricks (Vanderbilt Law School).

260. Probit regressions estimate binary dependent variables models, such as merger success, by fitting a gaussian cumulative distribution. See JEFFREY M. WOOLDRIDGE, ECONOMETRIC ANALYSIS OF CROSS SECTION AND PANEL DATA 457–59 (2002) for an in-depth description of probit and other binary response models.

interpret the economic significance of our results. We previously showed in Table 4 that 91 percent of the deals in our sample were successfully completed—in line with previous estimates of the unconditional average probability of success.[261] And in Panel B of Table 3, we showed that the average one-quarter change in short-term ownership is 11.2 percentage points. In terms of the marginal effects, a one-percentage-point increase in short-term ownership is associated with a 0.30 percentage-point increase in merger success from an unconditional average probability of 91 percent. Thus, if we extrapolate linearly then the average merger arbitrage activity changes merger likelihood by 3.4 percent (0.30 x 11.2 percent), which can be interpreted to mean that increased merger arbitrage has a statistically significant positive effect on deal completion. As an additional example, a deal without any increase in short-term ownership (" ST=0") corresponds with a 87.6 percent likelihood of completion,[262] while a deal with a 10 percentage point—one standard deviation—higher-than-average arbitrageur participation corresponds with a 94 percent likelihood of completion. In other words, the risk of deal noncompletion drops from 12.4 percent to 6 percent, or by over 50 percent, when short-term ownership increases this much.

There are two different interpretations for the relationship between deal success and increases in short-term ownership. The first suggests arbitrageurs might simply consider the riskiness of deals and avoid those most likely to fail. However, this regression includes the postannouncement spread—the deal price over stock market price—as well as deal and firm characteristics, to control for possible sources of risk that may correlate with arbitrage activity. In fact, as expected, a higher spread does predict a higher likelihood of failure, confirming that arbitrageurs demand a higher compensation to buy shares in riskier deals. But most importantly, by controlling for these variables, the coefficient on the change in short-term ownership is not capturing risks that arbitrageurs price-in. Rather, we interpret this result as evidence in favor of the second interpretation: that short-term investors push for the deal's completion by voting in favor of the transaction.[263]

261. Hsieh & Walkling, *supra* note 228, at 618–19.

262. The likelihood of completion without any increase in short-term ownership is calculated as follows: 91 – (0.30 x 11.2) = 87.6.

263. Hsieh and Walkling reach a similar conclusion in their study. *Cf.* Hsieh & Walkling, *supra* note 228, at 642.

In addition, we shed light on a few other results on the relationship between deal characteristics and merger outcomes. For instance, self-dealing transactions lower the likelihood of deal success as these transactions are more often challenged by other stakeholders. Consideration also seems to matter: cash deals have a higher likelihood of merger completion. Of course, if a deal is challenged by a competing bid, then subsequent bids are generally higher and more frequent. Tautologically, then, if there are competing bids, the likelihood that any one deal is successful is lower.

To examine more closely the impact of the shift of shares into short-term holders' hands, we next examine those transactions with the highest and the lowest percentage changes in stock ownership. For example, when we look at the twenty deals with the greatest shifts, we find that they show a percentage shift to short-term investors ranging from approximately 40 percent to over 50 percent of all shares held by institutional investors. Not surprisingly, all of these twenty transactions obtained shareholder approval.

To get a more sophisticated view of these effects, in the second regression of Table 6 we break out the cases with the highest twenty percentage shifts ("Top 20%") and the lowest twenty percentage shifts ("Bottom 20%") and then rerun the regression in Table 6. By examining the coefficients of these two variables, we should be able to discern the impact on merger success of high and low shifts in short-term investor holdings.

The signs on the coefficients of both variables confirm our result, but only the Top 20 percent coefficient is statistically significant. It can be interpreted as evidence that in those mergers with large changes in shares from long-term holders into the hands of merger arbitrageurs, the risk of merger failure is higher by 2.8 percentage points than the average merger, whereas for the Bottom 20 percent there is an insignificant decrease of 2.7 percentage points relative to the average success rate.

While these overall percentage changes appear relatively small, it is important to remember Listokin's findings that "management wins the close ones."[264] As we saw in Table 6, the percentage shift out of the hands of long-term holders and into those of short-term merger arbitrageurs has important effects on merger completion rates. Even

264. Listokin, *supra* note 28.

small percentage shifts will enable corporate managers to push through shareholder votes to gain merger approvals.

VI. RECONSIDERING SELF-DEALING TRANSACTIONS

The data and analysis in the preceding Part challenge a key mechanism corporate law has long embraced for addressing one of the most prevalent issues that arise in corporations: self-dealing transactions. In its most basic form, self-dealing arises when directors, officers, or controlling stockholders directly or indirectly enter into contracts or transactions with a corporation in which they serve as a director, officer, or controlling shareholder.[265] All states now have conflict-of-interest statutes that address contracts or transactions in which a corporation's director or officer has such an interest.[266] Even beyond the state conflict of interest statutes, control stockholder self-dealing, although not the subject of such statutes, follows an analogous course to that provided by statute for director and officer self-dealing.[267]

In broad overview, self-dealing by any fiduciary results in that person having the burden of establishing the contract or transaction's fairness. This inquiry generally focuses on whether the deal bears the indicia of an arms-length transaction, so reviewing courts consider the

265. "Self-dealing" as used here is narrower than "conflict of interest" or bad faith as self-dealing covers transactions in which the fiduciary is either in privity of contract with the corporation or has a fiduciary or financial interest in an entity that is in privity with the corporation. Thus, we do not intend the expression self-dealing to include the broader range of duty of loyalty violations by officers or directors or for that matter oppressive or unfair behavior by a controlling party. *See, e.g.*, Kern v. Arlington Ridge Pathology, S.C., 893 N.E.2d 999, 1008 (Ill. App. Ct. 2008) (holding there to be no self-dealing involved when shareholder-directors vote to amend the company's articles of incorporation so that it provides greater flexibility for them to later increase their control of the firm). *See generally* 2 COX & HAZEN, *supra* note 2, §§ 10.11–.12 (distinguishing absence of good faith from self-dealing); Harold Marsh, Jr., *Are Directors Trustees?: Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966) (providing close analysis of cases whereby in a few decades courts and legislatures moved from deeming self-dealing transactions voidable to upholding transactions if they were fair or impartially approved).

266. *See, e.g.*, CAL. CORP. CODE § 310 (West 2018); DEL. CODE ANN. tit. 8, § 144 (West 2018); N.Y. BUS. CORP. LAW § 713 (McKinney 2019); MODEL BUS. CORP. ACT §§ 8.60–.63 (AM. BAR ASS'N 2016).

267. *See, e.g.*, Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) ("[A]pproval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff.").

price as compared to market value,[268] the level of disclosure surrounding the matter,[269] and whether the transaction was the product of negotiations by independent parties.[270] The breadth of such a fairness inquiry, when coupled with the fact that the conflicted party has the burden of proof, is daunting, and all the more so if there is also fear that this inquiry may be plagued by hindsight bias.[271] Statutory provisions and common law doctrine have created two alternatives to the blunderbuss fairness inquiry: good-faith independent ratification by either independent directors or the disinterested shareholders.[272] When such impartial approval occurs, courts regularly conclude that the adverse inference that arose solely because of the demonstrated self-dealing by the director, officer, or controlling stockholder disappears, such that the contract thereafter is viewed as any other business transaction arrived at in good faith and at arm's length.[273] That is, independent-director or shareholder approval restores the presumption of the business judgment rule so that anyone questioning

268. *See, e.g.*, Kim v. Grover C. Coors Tr., 179 P.3d 86, 92 (Colo. App. 2007); Johnson v. Witkowski, 573 N.E.2d 513, 521–22 (Mass. App. Ct. 1991); Straight v. Goss, 678 S.E.2d 443, 452–54 (S.C. Ct. App. 2009).

269. *See, e.g.*, *Kim*, 179 P.3d at 93–94; Dynan v. Fritz, 508 N.E.2d 1371, 1378 (Mass. 1987); State *ex rel.* Hayes Oyster Co. v. Keypoint Oyster Co., 391 P.2d 979, 984 (Wash. 1964) (equating nondisclosure with inherent unfairness).

270. *See, e.g.*, Oberly v. Kirby, 592 A.2d 445 (Del. 1991) (emphasizing lengthy bargaining, transaction priced at midpoint of each party's position, and absence of viable alternatives).

271. For a discussion of how hindsight bias impacts the content of fiduciary duties in the corporate setting, see EISENBERG & COX, *supra* note 217, at 625–27 (explaining how more than ordinary negligence is required for breach of care in corporate setting out of concern that hindsight bias otherwise may impose liability for justifiable risk taking by managers; however, with loyalty violations, such as self-dealing, second guessing in light of post-transaction events remains a possibility).

272. There is an academic debate over whether these measures are necessary or value maximizing. *See generally* Alessio M. Pacces, *Procedural and Substantive Review of Related Party Transactions: The Case for Noncontrolling Shareholder-Dependent Directors*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 25, at 181 (arguing that minority-elected directors are the most efficient method of monitoring value decreasing related party transactions); Rock, *supra* note 25 (arguing that majority of minority votes do not greatly harm nor greatly benefit minority shareholders); Fernán Restrepo, Judicial Deference, Procedural Protections, and Deal Outcomes in Freezeout Transactions: Evidence of the Effect of *MFW* (Mar. 5, 2018) (unpublished manuscript), https://ssrn.com/abstract=3105169 [https://perma.cc/PH6N-JSZA] (arguing that the *MFW* legal standard provides a net benefit to minority shareholders in squeezeout transactions).

273. *See, e.g.*, Rosenfield v. Metals Selling Corp., 643 A.2d 1253, 1266 (Conn. 1994); Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997).

that transaction has the burden of proof that the approving parties acted in bad faith or were grossly negligent.[274]

We do not believe that the empirical evidence and reasons developed above necessarily cause the contemporary approach to self-dealing to be reconsidered; they do call for clarification of what such approval does not mean, at least with respect to state conflict-of-interest statutes. As first developed, state conflict-of-interest statutes sought to change prevailing judicial avoidance of contracts or transactions when there was evidence that the contract directly or indirectly involved a director or officer. By the time the first conflict-of-interest statute was enacted, the modern cases had already moved beyond automatic avoidance and upheld deals if they were shown to be fair and independently approved. Initially, conflict-of-interest statutes embraced this modern approach, but generally, they were not regulatory. In the intervening decades, a good deal of uncertainty surrounds just what effect should be accorded impartial director or shareholder approval.[275]

This Article strongly counsels that courts should not be indifferent to whether self-dealing was approved by the directors or the shareholders because the individual contexts behind these decisions are vastly unique. Of the two, the directors are, on paper, in the better position to protect the corporate interest when addressing self-dealing. Among the advantages that the board enjoys is better access to information and capabilities to evaluate information. This advantage exists for three main reasons. First, board members are the quintessential insiders with knowledge of information not readily available to the general public. Second, the board does not have the collective action problems that shareholders do; directors not only engage easily among themselves, but also, more importantly, they are better able to deliberate about the transaction with greater depth than shareholders, who have no means to probe more deeply than the proxy statement. Finally, directors enjoy the power of the purse as they can

274. *See, e.g.*, Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R., 875 F.2d 549, 552–53 (6th Cir. 1989); *Rosenfield*, 643 A.2d at 1266.

275. *See* Douglas M. Branson, *Assault on Another Citadel: Attempts To Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375, 385–90 (1988) (closely reviewing the 1988 amendments to the Model Business Corporation Act that effectively removed from any scrutiny transactions that are independently approved); Marsh, *supra* note 265 (providing the classic discussion of how the common law's early approach to conflict of interest quickly morphed from automatic avoidance of self-dealing transactions to inquiries into the challenged transaction's fairness).

deploy corporate funds to retain advisors and others to enable them to make a truly informed decision.

As seen earlier, many shares are held by financial institutions, who can have their own conflicts of interest that influence their ratification decision and who, importantly, face no fiduciary obligation when voting that serves to regulate any conflict they have. By contrast, directors, whose vote can serve as a ratifying vote as a threshold matter, are independent of the underlying contract or transaction and are subject to fiduciary obligations in their review and approval of the self-dealing transaction. Independent directors, when asked to approve a self-dealing transaction, do not face a bird-in-the-hand situation of the type discussed in the Introduction, which appears to dwarf the heuristics that guide even sophisticated hedge funds in supporting a majority of the minority votes in self-dealing mergers. Shareholders can naturally understand that withholding approval means no transaction, whereas the independent directors generally enjoy the position to negotiate a better outcome. That freedom also disconnects the underlying self-dealing conduct from the contract or transaction; that is, a self-dealing contract or transaction submitted to the board of directors is not bundled in the same way that resolutions presented to the shareholders might be. Because the boardroom is a forum for deliberation, it allows boards to withhold approval while negotiating for improved terms. Further leverage exists for the board, as it is able to qualify its approval with an articulation that it is only authorizing the contract or transaction and not necessarily affirming the fiduciary's conduct.

The above are a few of the reasons why approval by the board of directors and the shareholders, in light of the data and analysis developed in this paper, should be treated very differently. We do not quibble with the contemporary view that a self-dealing transaction that is the product of a fully informed impartial vote of the directors should be reviewed differently than if that transaction had no impartial approval. This seems supported by logic and is likely legislatively compelled by state conflict-of-interest statutes, which provide three separate alternative mechanisms for upholding self-dealing transactions. First, a transaction could pass a fairness inquiry. Second, the transaction could be approved by the impartial directors. Third, the transaction could be approved by the shareholders. Importantly, the latter two avenues do not have to pass the fairness requirement. Impartial approval must have some benefit over a fairness inquiry. How should the approval by the weaker impartial body—the shareholders—be treated differently from the approval by the board of directors? The necessary predicates for shareholder approval to cleanse a matter is that their approval must come after full disclosure and not be coerced.[276] Consistent with the operation of conflict-of-interest statutes, the burden of proof for each of these should be on the party who seeks to invoke the cleansing effect of the shareholder vote. The analysis in this Article supports the view that at least in the case of alleged ratification by the shareholders, the inquiry into each of these predicate requirements should be more sweeping than it has been.

Even though the absence of coercion is the *sine qua non* for shareholder approval, our analysis and data demonstrate that the courts have been woefully narrow in what they hold to be coercion. As discussed earlier, *Liberty Broadband* did hold that directly bundling negative- and positive-value outcomes into connected resolutions caused coercion, such that the shareholders' ultimate approval did not cleanse the misconduct. Our Article makes the case that shareholder approval of merger transactions offering a premium of any amount above the pre-announced market price is inherently coercive. This explains why Professor Rock's study of MOM transactions found no instance in which shareholders withheld their approval.[277] Our data in Part V show that substantial ownership changes among institutional investors occurs in the quarter the deal is announced, so that these new owners are committed to approving the deal by the investment they have already made. Thus, when the proxy statement later discloses details indicating possible unfairness—or worse, management laxity or conflicts—the vote by the arriving owners is hardly free of financial duress. From our perspective, coercion should, at least in the case of shareholder ratification, be much more sweeping than classic bundling considerations.

Likewise, a court's inquiry into whether material facts were disclosed should be more inclusive than in the case of the board of directors. As seen earlier, directors, whether on the full board or a committee of the board, have a chance to interact with the transaction and its supporters. Shareholders acting only through the proxy mechanisms do not. This distinction implicates both what needs to be disclosed and how the disclosed information is presented. Certainly more than a neutral narrative of the transaction's terms, such as occurred in the proxy statement at the heart of *Corwin*, is needed.

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276. *See supra* Part IV.A.

277. *See supra* note 25 and accompanying text.

There is no easy template for what is to be disclosed and how disclosure should be made. Perhaps instructively, in self-dealing transactions, the defendant bears the burden of disclosing, in an understandable manner, the facts necessary for the shareholder to excuse the self-dealing. Minimally, companies should be required to make a detailed and balanced disclosure of the ways in which the conflicted parties benefit from the transaction, presenting the potential legal and financial arguments bearing on whether misconduct has occurred and indicating whether the transaction is in the interest of the company or its shareholders.

CONCLUSION

Corporate statutes condition significant corporate transactions on shareholder approval. This is an important mechanism for protecting shareholders. While we champion the voice of the shareholder in votes and in corporate governance issues, for the reasons we develop in this Article, we believe that the shareholder vote is deeply qualified. Thus, at a time when ownership of public companies is increasingly concentrated in financial institutions, providing a basis for courts and commentators to call for curbing protective features of corporate law, we caution judges and academics that the time is not yet at hand for such a laissez faire approach. Shareholders, even large, well-financed hedge funds, face too many forces that limit their ability to single out managers for misconduct in a transaction that the shareholders are asked to approve. As developed here, their voice in approving the transaction, even one separately identified as involving self-dealing, should be understood as only approving the transaction itself and not the conduct that preceded it.

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