Voting (Insincerely) in Corporate Law

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Voting lies at the center of collective decision-making in corporate law. While scholars have identified various problems with the voting mechanism, insincere voting—in the forms of strategic voting and conflict of interests voting—is perhaps the most fundamental. This article shows that insincere voting distorts the voting mechanism at its core, undermining its ability to determine transaction efficiency. As further demonstrated, strategic and conflict of interests problems frequently coincide with one another: voting strategically often means being in conflict, and many fact patterns present aspects of both problems. Finally, this article claims that although the two problems have seemingly different solutions, these solutions are essentially similar in nature: all solutions to insincere voting are variations on two basic rules, namely, property rules and liability rules.

INTRODUCTION

Voting is the most commonly accepted method for extracting the "group preference" from among the disparate and diverging subjective opinions of a corporation's security holders. Nonetheless, the proper functioning of the voting mechanism is often endangered due to *insincere voting*. The mechanism cannot operate properly unless every security holder votes sincerely, that is, in accordance with his or her personal belief regarding the value of the transaction to the corporation as a whole.[1] Underlying the voting mechanism is a statistical proposition that a majority vote for a corporate transaction represents the "correct" choice.[2] If the majority of security holders

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[1]   Kenneth Arrow, Social Choice and Individual Values (2d ed. 1963).
[2]   "Correct" means the choice that will maximize the group's expected return from the

believe that a particular transaction is efficient, it probably is. However, when security holders cast their ballots in accordance with the way other security holders are going to vote ("strategic voting") or in line with their own personal interests in a deal ("conflict of interests voting"), this statistical proposition collapses. Such insincere voting undermines the voting mechanism itself and, along with it, the ability to distinguish efficient transactions from inefficient ones.

This article explores both types of insincere voting—strategic voting and conflict of interests voting—as well as the solutions that are available to contend with this phenomenon. Part I reviews the nature of these two types of voting, presenting the contexts in which they tend to arise. Part II demonstrates that strategic problems and conflict of interests problems are fraternal twins: strategic voting can also be construed as conflict of interests voting, and many fact patterns present aspects of both problems. Finally, Part III argues that there are two possible solutions to both problems. The first, property-rule protection, which validates only consensual transactions, affords *ex ante* protection to minority security holders against pressure to enter into a deal. The second, liability-rule protection, affords *ex post* protection to the voter, allowing the transaction to take place without the consent of the minority, but affording that minority the right to adequate compensation.[3]

I. THE VOTING MECHANISM AND INSINCERE VOTING

One of the primary objectives of corporate law is to facilitate efficient transactions and to prevent inefficient deals from taking place. In market economies, efficiency is achieved when assets are transferred from those who value them less to those who value them more.[4] Because the typical actor in the market wants to increase the value of her holdings, the consent of both parties to a transaction serves as an approximate indicator of its efficiency.[5] Suppose, for example, that *A* owns a piece of property that she values at

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decision. *See* Shmuel I. Nitzan & Uriel Procaccia, *Optimal Voting Procedures for Profit Maximizing Firms*, 51 Pub. Choice 191 (1986).

3   *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089 (1972).

4   Efficient in the sense of Pareto-efficiency: a transaction that improves the situation of at least one of the parties without harming anyone. Richard Posner, Economic Analysis of the Law 13 (4th ed. 1992).

5   *See id.* at 99.

$100 and that *B*, her neighbor, values it at $200. If *B* buys the property, the transaction will be efficient because it will involve a transfer of an asset from a person who values it less to a person who values it more. Moreover, *A* would not agree to sell the property and *B* would not agree to buy it unless both were to determine the transaction as being subjectively worthwhile.[6] Put another way, both *A* and *B* would consent to the transaction precisely because it is efficient.

An important problem from the perspective of corporate law is that a group of security holders, as opposed to a single individual, needs to approve corporate transactions.[7] Collective decision-making muddies the concept of consent. Due to the divergence of opinions among the members of the security holders group as to the value of corporate transactions, attaining efficiency becomes problematic. Within the context of collective decision-making, therefore, efficiency must be identified on the basis of the "group preference" regarding what would maximize the expected return for the group as a whole.[8] The group preference is the equivalent of the group's consent.

Voting is most commonly accepted as the best method for extracting the group preference from among the disparate and diverging subjective opinions of the group of security holders. The majority view of the security holders reflects the optimal choice for the group as a whole,[9] providing the best approximation of the choice that would be implemented if a single individual, rather than a group, were making the decision.[10] The presumed correlation between the group preference and the majority view rests on a statistical proposition: assuming each security holder is more likely to be

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6   *See* Timothy Muris, *Cost of Completion or Diminution in Market Value: The Relevance of Subjective Value*, 12 J. Legal Stud. 379 (1983).

7   Every investor group is party to a contract with the company in which it has invested. Shareholders, for example, are party to a contract embodied in the company's charter or bylaws, while bondholders are party to a loan contract embodied in the particular issue's trust indenture.

8   *See* Nitzan & Procaccia, *supra* note 2.

9   *See* Shmuel I. Nitzan & Jacob Paroush, *Optimal Decision Rules in Uncertain Dichotomous Choice Situations*, 23 Int'l Econ. Rev. 289 (1982). Another approach to the voting process is that majority rule facilitates transactions that, although not beneficial to all members of the group, represent a net gain. Ronald J. Gilson & Bernard S. Black, The Law and Finance of Corporate Acquisitions 643 (2d ed. 1995). Under this view, majority rule is analogous to the Kaldor-Hicks Efficiency standard, under which the overall welfare is increased even though a minority is injured as a result. *Id.* at 644.

10 Lucian A. Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 J. Legal Stud. 197 (1988).

correct than mistaken, the choice made by the largest number of voters will most probably be the "correct" one.[11] Hence, it is certainly in the minority's interest, *ex ante*, that the majority view prevail.[12]

While the voting system is an acceptable mechanism for determining the group preference, it only functions as an indicator of transaction efficiency when every individual in the group "votes sincerely," namely, in accordance with his or her genuine personal assessment of the transaction's desirability for the group.[13] Whenever voters take into account how other members of the group will vote ("strategic voting")[14] or else vote according to their assessment of the transaction's value to them personally outside of the group ("conflict of interests voting"),[15] the voting procedure ceases to reflect the group preference. When a voter votes strategically, for example, the majority position no longer enjoys a greater probability than the minority's position of being the "correct" choice. In other words, the statistical proposition underlying the correlation between the *majority view* and the *group preference* is no longer valid. This is true even if all of the individuals in the group participate in the vote. Likewise, conflict of interests voting undermines the voting system's ability to ascertain the group preference by shifting the focus away from the transaction's value to the group as a whole towards the voters' personal stakes in the deal. Because the goal of corporate law

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11 *See* Ronald J. Gilson & Reiner H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549 (1984).

12 *See* Michael J. Taylor, *Proof of a Theorem of Majority Rule*, 14 Behav. Sci. 228 (1969) (behind a perfect veil of ignorance regarding proposals that will be put to a vote and regarding the expected stance to be taken in the votes, the voter will prefer simple majority rule).

   Despite the subjective belief of those in the minority that their choice is "right," they will still recognize it as, statistically speaking, "wrong" (i.e., that majority rule will prevent an error both in the immediate vote and, more generally, in the sum of future ballots). This is true even though in certain cases, the minority will be proven right *ex post facto*, just as A might sell an asset to B and later regret her decision. Such a possibility is of no concern; in either case, the goal is to determine *ex ante* whether a transaction is efficient at the moment of its performance. Richard A. Epstein, *Holdouts, Externalities and the Single Owner: One More Salute to Ronald Coase*, 36 J.L. & Econ. 553, 558 (1993).

13 Amartya Sen, *Behavior and the Concept of Preference, in* Rational Choice 60 (Jon Elster ed., 1986).

14 *See* Zohar Goshen, *Controlling Strategic Voting: Property Rule or Liability Rule?*, 70 Cal. L. Rev. 743 (1997).

15 *See* Zohar Goshen, *Voting and the Economics of Corporate Self-Dealing: Theory Meets Reality, at* http://papers.ssrn.com/sol3/papers.cfm?cfid=447349&cftoken=98858720&abstract_id=229273.

is to facilitate efficient transactions, strategic and conflict of interests voting raise serious legal issues, as explained below.

A. Strategic Voting

The voting system is susceptible to two kinds of strategic voting: natural strategic voting and coercive strategic voting.[16]

1. Natural Strategic Voting: The Free-Rider and Holdout Problems

Natural strategic voting occurs "naturally," that is to say, without the intervention of third parties. The mere convergence of a number of variables forces voters to take account of the way in which other members of the group will vote. This often occurs in the context of the free-rider and holdout problems.

a. *The Free-Rider Problem.* The free-rider problem arises whenever a transaction *furthering the interests of a given voter* can be performed despite that same voter's opposition to the transaction. This opposing voter can enjoy the benefits of the transaction by free-riding on the efforts of other voters who support and enable the transaction. The following is an example in which the "vote" is reflected through the "action" of a shareholder. Suppose that a corporate raider wishes to take control of a target company, A, and that in order to complete the takeover, the raider must acquire 50% of the existing shares. In order to induce the shareholders to tender, the raider offers to buy shares at some premium above the trading price. Assuming that the company's market value on the day of the offer reflects its true value, shareholders should be eager to tender for the premium offered. Suppose, however, that some shareholders believe that the premium offered reflects only a fraction of the expected increase in the value of the company under the raider's new management. Banking on the fact that their peers will

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16 *See, e.g.,* John C. Coffee & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations,* 58 U. Chi. L. Rev. 1207 (1991); Victor Brundey, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good,* 105 Harv. L. Rev. 1821 (1992); Note, *Distress-Contingent Convertible Bonds: A Proposed Solution to the Excess Debt Problem,* 105 Harv. L. Rev. 1857 (1991). In some instances, coercive voting tactics are implemented as a response to the deficiencies inherent in the voting system (i.e., natural strategic voting). *See, e.g.,* Mark J. Roe, *The Voting Prohibition in Bond Workouts,* 97 Yale L.J. 232 (1987); Lewis S. Peterson, *Who's Being Greedy? A Theoretical and Empirical Examination of Holdouts and Coercion in Debt Tender and Exchange Offers,* 103 Yale L.J. 505 (1993).

tender the requisite 50%, they hold on to their stock, seeking to enjoy the increased value that will be produced after the takeover has been completed. Obviously, these shareholders will be taking a "free ride" on the tendering shareholders who, in tendering for the smaller premium, will incur the cost of transferring control. Moreover, this "free ride" will come at the expense of the new controlling shareholders, who will incur additional expenses of their own in bringing about new and better management. The most troubling aspect, however, is the potential foiling of efficient transactions: if most shareholders become "free-riders," not enough shares will be tendered and a desirable takeover attempt will fail.[17]

b. *The Holdout Problem.* Like the free-rider problem, the holdout problem illustrates the way in which natural strategic voting comes into play. The holdout problem takes place whenever a transaction *furthering the interests of a given voter* can be performed only with that voter's support for the transaction. The voter, however, opposes the desired transaction, attempting to extract additional value from the deal. Suppose that Corporation *B* is failing financially and that the management, in an effort to ease the debt, asks for the bondholders' consent to an interest rate decrease. Because of the nature of the change, the unanimous consent of all the bondholders is required.[18] As a result of this unanimity requirement, each bondholder knows that the success or failure of the company depends upon her consent: with a lower interest rate, the company will be able to raise additional capital; without it, the company will fail and go bankrupt. Despite the fact that this decrease in the interest rate may be in the best interests of all the bondholders, an individual bondholder may vote strategically against the change, withholding her consent until she is paid a higher price for her support. The holdout's demand can be directed at the other party to the transaction, requiring an increase in the price offered to all the members of the group or just to the individual holdout, or else at the other members of the holdout's group, requiring uneven distribution of the proceeds of the transaction. Unfortunately, however, if too many bondholders "hold out," the restructuring will not occur and the company will go bankrupt.[19] The most troubling aspect of a strategic holdout is that like free-riding, it too can lead to the failure of efficient transactions.

c. *Free-Riders and Holdouts Compared.* Though both free-riding and

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17 *See* Sanford J. Grossman & Oliver Hart, *Takeover Bids, the Free Rider Problem and the Theory of the Corporation*, 11 Bell J. Econ. 42, 43 (1980).

18 *See* Roe, *supra* note 16.

19 *See, e.g.*, Coffee & Klein, *supra* note 16.

holding out are examples of natural strategic voting, they have certain characteristics that distinguish them from one another.[20] In the holdout situation, a party refuses to give her consent, knowing that ultimately she will be better off even if the transaction is approved as is. She opposes the transaction knowing from the outset that she will support it at a later stage for a higher price. In stark contrast, the free-rider opposes a given transaction to the end. Indeed, the benefit from free-riding—as opposed to holding out—is that the transaction can go through without the free-rider's consent, thereby enabling her to benefit from the transaction while saving the cost of facilitating it.

A second difference relates to the level of consent required. Holding out is more common where a unanimous or near-unanimous vote is needed. This is because as the level of the required consent approaches unanimity, each individual vote becomes more important and each voter more powerful. At the extreme end, when unanimity is required, each security holder has veto power. Free-riding, on the other hand, is only possible in situations where a transaction can succeed in spite of individual opposition. In other words, if the free-rider were to believe that her vote could influence the outcome, she would be unable to free-ride, because her vote would cause the transaction to fail and she could not expect to profit by taking a free ride. Indeed, the free-rider banks on the transaction's success despite her opposition, looking to reap profits by seeing her opposition through to the end.

To illustrate this distinction, consider again the example of Corporation *B*. If we were to change the majority needed to approve the reorganization plan from 100% to 50%, holdouts would decrease because each individual voter would have less power to "block" the transaction. Moreover, free-riding would be impossible, because the majority's decision would bind all bondholders—including those in opposition. Suppose, however, that instead of reducing the required majority, Corporation *B* asks its bondholders to exchange their old bonds for new bonds (with a lower interest rate) and that 50% of the bonds have to be exchanged in order for the restructuring to succeed. In this instance, the holdout problem would diminish because individual bondholders would have less power to frustrate the reorganization. The free-rider problem, however, would dominate the scenario because even if a majority of individual voters were to consent to the exchange, dissenting bondholders would continue to be paid at the higher interest rate. Indeed, the rational bondholder would prefer to hold on to her bonds, because after the restructuring, the original bonds will pay a higher rate of interest than

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20 *See* Lloyd Cohen, *Holdouts and Free Riders*, 20 J. Legal Stud. 351 (1991).

the new bonds. Put another way, the rational bondholder would prefer to take a free ride on those bondholders who exchange their bonds and who, in doing so, pay the cost of keeping the company afloat.

Finally, whereas free-riding can take place only when several voters are involved, a holdout is possible even when the consent of only one individual is needed. A free-rider, after all, cannot free-ride on herself. Indeed, the benefit of free-riding is rooted in the ability to take advantage of the decisions of others. In contrast, the holdout party may withhold her support in an attempt to cause the bidder to raise the offer, even if she is the only one to whom the offer is made.[21] Nonetheless, an important difference still exists between individuals and groups in the holdout context. When the holdout takes place in the framework of a transaction between individuals, the holdout party knows that she alone will bear the risk of crossing the fine line between tough negotiations and excessive demands that may result in the loss of a beneficial transaction (even at the initially offered price). In a transaction involving collective decision-making, on the other hand, since the risk of losing the transaction due to her excessive demands is borne equally by all members of the group, she is in fact externalizing an uncompensated risk of losing the deal to the other members of the group. In this sense, the holdout problem is more troubling when collective decision-making is involved.

2. Coerced Strategic Voting: The Prisoner's Dilemma and the Coordination Problem

Natural strategic voting poses a problem for market players in that it disrupts the voting mechanism and causes efficient transactions to fail. Accordingly, lawyers, investment bankers, and other third parties have devised techniques to minimize the potential of its occurrence. Though these parties sometimes aim to restore the integrity of the voting system, they are more often seeking to distort the voting mechanism towards their own ends.[22] Whatever the motivation, though, the techniques they employ often exacerbate—rather than diminish—the problem of strategic voting: voters are forced to agree to transactions they find undesirable because they are forced into a prisoner's dilemma or face a coordination problem. The result is

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21 It is important to stress that the phenomenon described here as a holdout relates to a situation in which from the perspective of the individual holding out, the transaction is desirable and her behavior is no more than an attempt to make the transaction even more desirable for her. It is impossible to actually determine whether opposition to a particular transaction developed because the offering price was too low to begin with or for the purpose of forcing a more desirable transaction.

22 *See supra* note 16.

coercive strategic voting, in which voters are entrapped in purposely-crafted dilemmas.

In the corporate context, a number of coercive voting tactics, which undermine security holders' ability to negotiate as a group, are employed. These tactics typically include three elements. First, they structure the vote so that every individual can act independently of the group.[23] This is usually accomplished by allowing "voting by action" or by instituting an indirect voting system in which the majority position does not bind the entire group and uniformity of action is not required. Second, coercive strategic tactics increase the dependency of expected profits on the actions of other group members. For example, a transaction may be conditioned on the support of a given percentage of voters, putting opposing voters in the minority after the transaction takes place. Finally, coercive voting techniques tend to punish security holders who oppose transactions by preventing them from profiting as free-riders or by putting them in a worse position than they would have been had they consented to the transaction in the first place. These tactics are the building blocks for entrapping voters in a prisoner's dilemma or a coordination problem.

a. The Prisoner's Dilemma. The prisoner's dilemma represents a situation in which a third party is able to manipulate and take advantage of an individual's options. Game theory describes the prisoner's dilemma as follows. Two individuals—Prisoner 1 and Prisoner 2—rob a bank and are arrested by the police. At the time of their arrest, they are found in possession of an unlicensed firearm. Though the police know that both committed the robbery, they have no proof to support the charge at trial. They therefore separate the two and offer each the following deal: If both confess, the district attorney will agree to a five-year sentence (half the maximum sentence for the crime) for each. If neither confesses, they will both serve one year for unlawful possession of a firearm. Finally, if one confesses and the other does not, the partner who confesses will be given the opportunity to turn state witness and avoid imprisonment altogether, while the other partner will receive the maximum ten-year sentence.[24]

Clearly, each prisoner has one dominant strategy: confess to participation in the robbery. This strategy is not dependent on the other prisoner's actions. Consider the situation from the perspective of Prisoner 2. If Prisoner 1 does

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23   In most cases, the offer is to exchange one security for another. The exchange offer, just as the sale of a security, is an activity we are accustomed to viewing as a derivative of ownership of a security, which every voter is free to do individually.

24   *See* R. Duncan Luce & Howard Raiffa, Games and Decisions 95 (1957).

not confess, Prisoner 2 will be better off admitting his participation in the robbery. Prisoner 2, after all, can avoid serving any jail time by turning state witness. Even the charge of possession of an unlicensed firearm will be dropped. Moreover, if Prisoner 1 confesses, Prisoner 2 will still be better off confessing, because by admitting to her participation in the crime, she will be given a lighter sentence: five years in jail rather than the maximum ten-year term. Prisoner 1 will be faced with the same choices as Prisoner 2, so she, too, will choose to confess. Therefore, the outcome of this prisoner's dilemma will always be that both prisoners confess and both are sentenced to five years in jail. However, had they both denied participation, they both would have been sentenced to only one year in prison. That is to say, because the two prisoners share the same dominant strategy, they together attain an inferior equilibrium that is to their mutual detriment.

Significantly, the prisoner's dilemma is not a coordination problem, but, rather, a conflict of interests problem. In other words, even if the prisoners could meet before the interrogation to determine a plan of action, they would not be able to escape the dilemma. Instead, the dilemma would simply play itself out at another level.[25] To illustrate: If Prisoner 2 were certain that Prisoner 1 would stand by her word and deny her participation in the robbery, she would still have an incentive to confess to the police. After all, though her defection would result in Prisoner 1 being sentenced to a ten-year prison term, it would also allow her to turn state witness and avoid serving any jail time. Moreover, if Prisoner 2 were not sure that Prisoner 1 would keep her end of the deal, she would still be better off confessing to the police. After all, if Prisoner 1 were to cave-in to the pressure or to follow her own interests and take advantage of the deal herself, Prisoner 2 would need to confess in order to avoid the maximum ten-year sentence. In other words, due to the conflict of interests and the incentives influencing each prisoner, both prisoners will choose to defect and confess in spite of their coordinated positions.

Vote buying can be considered an example of the prisoner's dilemma in the corporate context.[26] When someone purchases a share, she also purchases a bundle of rights including the right to dividends, the right to vote, and a right to a share of the company's remaining assets upon dissolution. Significantly, the right to vote also includes the right to amend the entire bundle of rights attached to each share or to affect that nexus of rights by voting on policies related to the company's business or to shareholder rights. Assuming that the right to vote is attached to the other rights, the shareholder will utilize her

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25 *See id.* at 96-97.
26 For a discussion on vote buying, see Goshen, *supra* note 14.

vote in a way that preserves or increases the value of the bundle as a whole. However, if the shareholder sells the right to vote, the purchaser will not exercise that right under the same set of incentives. This creates a substantial risk that the shareholder who sold the right to vote will be worse off, as the purchaser may now make decisions that will dilute the value of the remaining rights in the seller's share.[27]

Because vote buying creates a gap between those who own shares and those who merely own the right to vote, it also creates a prisoner's dilemma. An individual shareholder has incentive to sell her right to vote.[28] As an individual small shareholder, she knows her vote is not pivotal and is thus worthless. In any event, the fate of the voting will be determined by the other voters in her group. Thus, any positive price for the vote is a good deal for the individual voter. Indeed, as a member of a large group, the individual shareholder banks on the fact that the majority will protect *her* interests by protecting *their own* and refusing to sell their votes. If this happens, the purchaser of her vote will have little power to effect detrimental change, while she will get a positive price for the vote in any case. Moreover, because making the right decision in a corporate vote involves high information costs, the profit the shareholder can hope to earn by selling her right to vote is often greater than any profit she could garner by retaining it. Of course, if every shareholder decides to sell his or her right to vote, the situation changes. More specifically, the same individual small shareholder will find herself facing a prisoner's dilemma. If she retains her right to vote, she will find herself at a double loss. First, her shares will be diluted because the purchaser will now have enough power to bring about significant corporate change. Second, she will lose the premium the purchaser offered in exchange for her vote. Therefore, whatever the other shareholders do, she is always better off selling her vote.[29] As a prisoner's dilemma situation, vote buying cannot be solved through coordination, as each voter is in a conflict of interests vis-à-vis

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27 *See, e.g.*, Frank Easterbrook & Daniel Fischel, *Voting in Corporate Law*, 26 J.L. & Econ. 395, 410 (1983).

28 *See* Robert Charles Clark, Corporate Law 390 (1986).

29 To understand this problem more clearly, imagine that Corporation Z's shares are selling at $10 each and that the price offered for the voting rights is $2 per share. Imagine further that if all of the shareholders sell their voting rights, the value of the shares will decrease to $7 apiece due to the dilution created by the votes' buyer. Under this scenario, each shareholder will seek to sell her voting rights. After all, if she sells and the others do not, she will gain the $2 premium without suffering any dilution. Conversely, if the other shareholders sell and she does not, she will be doubly worse off. She will have received no premium, and her shares will be diluted from $10 to $7 apiece.

other voters. That is to say, if a voter is certain that other voters will not sell their votes, she has an even greater incentive to sell her own. After all, she knows for a fact that she will be able to secure a premium without suffering any dilution. Clearly, however, if all the voters think this way, dilution will occur.

b. *The Coordination Problem.* The coordination problem represents a situation in which all the voters have identical interests but are unable to agree on their preferred alternative because they are unable to coordinate their positions. To illustrate, suppose that the prisoners in the prisoner's dilemma scenario described above are offered the following deal: If neither confesses, both will be set free. If both confess, both will be sentenced to five years in jail. If one confesses and the other does not, the one who cooperates will be sentenced to one year in jail, while the other will be sentenced to ten years. In this situation, each prisoner's optimal strategy depends on the other's actions. Consider the situation from the perspective of Prisoner 2. If Prisoner 1 denies participation in the robbery, Prisoner 2 will be better off denying participation as well. After all, if neither confesses, neither will go to jail. Similarly, if Prisoner 1 confesses, Prisoner 2 should confess as well so that she gets a five-year sentence rather than the maximum ten. Obviously, if both prisoners act rationally and with perfect information, they will both deny the charges and be set free. The problem, however, is that the prisoners do not have perfect information about the expected benefits or about the other prisoner (e.g., her abilities, her rationality, and the information in her possession as to the expected benefits). Both will, therefore, most surely confess. Put another way, because of their inability to coordinate their positions, the prisoners will make decisions that are to their mutual detriment.

This point can be clarified by considering what would happen if the prisoners were allowed to meet and coordinate their positions. Assume that the prisoners meet and agree to deny participation in the robbery. If Prisoner 2 believes that Prisoner 1 will abide by their agreement, she will certainly abide by it too. Moreover, in this instance, Prisoner 2 has no reason to fear that Prisoner 1 will defect. Prisoner 1, after all, will only worsen her plight by defecting. In other words, under the coordination problem scenario, self-interest reinforces—rather than undermines—the agreement between the prisoners. Significantly, if the prisoners are repeat offenders, they can coordinate their positions even without meeting. In other words, over time, they will be able to coordinate their actions by signaling one another.[30]

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30 Some studies have found that in games repeated many times where the players do not know when the game will end, coordination can exist even if the players are

The issue of "exit consent" illustrates how the coordination problem operates in the context of corporate law. Exit consent is implicated in tender offers for bonds that carry protective covenants. As a general rule, protective covenants are amended either by a regular majority or by a super majority. However, because stripping a bond of its covenants increases its risk and reduces its value, bondholders are almost always opposed to this kind of amendment in the absence of proper compensation. That said, in some instances, third parties can force bondholders to agree to revoking protective covenants, even without any compensation, by making a tender offer that places the bondholders in a coordination problem. Under the terms of this kind of an offer, the bondholder must agree to vote to amend the protective covenants before tendering her bonds for the price offered. In other words, in order to "exit," the bondholder must "consent" to revoke the covenants. Because each bondholder does not know how the other bondholders will respond to the offer, all of the bondholders will tender and consent to the revocation—even if they value the bond above the premium offered. After all, if a bondholder tenders, she gets a premium above the market value. More important, if she does not tender but the other bondholders do, her bonds will be stripped of their protective covenants and become devalued. Assuming that all bondholders value their bonds above the offered premium, there will be no conflict of interests among the members of the group (i.e., no prisoner's dilemma). Thus, if allowed to coordinate, the bondholders will refrain from tendering their bonds and avoid stripping them of their covenants. However, being in a coordination problem and not knowing how the other bondholders will behave, a bondholder is forced to agree to a sub-optimal offer.[31]

In sum, strategic voting, whether natural or coercive, frustrates the voting mechanism's ability to serve as an efficient collective decision-making process. The result of a vote tainted by strategic voting is that it does not

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placed in the prisoners' dilemma. *See* Robert Axelrod, The Evolution of Cooperation (1984).

31 Significantly, though market forces mitigate the effects of coercion by creating competition among bidders, they cannot eliminate it entirely. Indeed, where there are several bids, competition among bidders will drive the tender price up, pushing the transaction closer to efficiency. Market forces could, however, hit the wall for several reasons: First, competition is not always possible. In some instances, for example, the group is prohibited from transacting with anybody other than those who are party to the security contract. Second, even when competition is viable, it does not always occur. Not every tender offer, for example, is met with a competing bid. Finally, there is not always a sufficient number of competitors. Indeed, even the sole owner who has several competing offers is not always able to close a deal.

reflect the group preference and the majority view does not represent the "correct" choice for the group.

B. Conflicts of Interests

Like strategic voting, conflict of interests voting undermines the voting mechanism's ability to ascertain whether or not a transaction is efficient.[32] A conflict of interests arises when some members of the voting group have personal interests that run counter to their interests as members of the group.[33] Conflict of interests voting distorts the voting mechanism by shifting the focus away from what is best for the group as a whole to what is best for each individual member. Consequently, conflict of interests voting undermines the voting mechanism's ability to determine the group preference.[34]

Conflict of interests voting arises in several different contexts in corporate law.[35] The "interested shareholder" scenario is one of the most common conflict of interests fact patterns. Suppose that Corporation X is considering a proposal to acquire Corporation Y. In the normal course of events, there will be differences of opinion among the shareholders as to whether or not the deal is worthwhile for the group as a whole. Notwithstanding these differences of opinion, if the voting mechanism is operating properly and everybody votes sincerely, the majority opinion will reflect the group preference. Suppose, however, that A, a controlling shareholder in Corporation X, is also the sole owner of Corporation Y. Shareholder A most assuredly will not view the results of the vote exclusively from the perspective of Corporation X.

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32 For a detailed discussion of conflict of interests problems, see Goshen, *supra* note 15.

33 The conflict of interests problem is only one manifestation of the fundamental "agency problem" that pervades corporate law. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976); William L. Cary & Melvin A. Eisenberg, Cases and Materials on Corporations 647-809 (7th ed., unabr. 1995).

34 *See* Arrow, *supra* note 1; Duncan Black, The Theory of Committees and Elections (1958).

35 *See, e.g.*, Kahn v. Tremont Corp., 694 A.2d 422 (Del. 1997); Kahn v. Lynch Communication Sys., 638 A.2d 1110 (Del. 1994); Wiegand v. Berry Petroleum Co., 1991 Del. Ch. Lexis 37; Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985); Cookies Food Prods. v. Lakes Warehouse, 430 N.W.2d 447 (Iowa 1988); Levien v. Sinclair Oil Corp., 261 A.2d 911 (Del. Ch. 1969); David J. Greene & Co. v. Dunhill Int'l Inc., 249 A.2d 427 (Del. Ch. 1968); Warshaw v. Calhoun, 221 A.2d 487 (Del. 1966); Ripley v. Int'l Ry. of Cent. America, 8 N.Y.2d 430, 209 N.Y.S.2d 289 (1960); Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952); Gottlieb v. Heyden Chem. Corp., 91 A.2d 57 (Del. 1952).

Indeed, unlike the ordinary shareholder, A may actually earn a net profit if Corporation X makes a "mistake" and pays too much. Put another way, since A is involved in both sides of the transaction and playing two opposing roles, she may actually profit at the expense of the group's minority.

When a voter stands on both sides of a transaction, the conflict of interests problem is especially apparent, but this problem also can arise in situations that appear far more innocent. Consider the following example: A group of voters are considering whether or not to amend the corporation's articles of association so as to provide that the holder of each share is entitled to ten votes instead of one. Suppose further that accompanying this amendment is a proviso that the additional nine votes shall be forfeited if the share is sold and that only continuous possession for a three-year period will restore the additional voting power.[36] On the surface, these changes apply equally to all of the shareholders. In practice, however, these changes may create two classes of shareholders, preserving or even increasing the advantage the controlling shareholders have over the minority: controlling shareholders, after all, are interested in long-term holdings, while minority shareholders tend to trade their shares much more frequently. The result will be that a controlling shareholder could have complete corporate control — including the ability to prevent a takeover—even though she controls less than 50% of the available capital.[37]

Conflict of interests problems can also arise in the context of the "interested director." Suppose, for example, that a corporation is considering whether or not to buy an asset. Ordinarily, the board of directors will consider the value of the asset to the corporation and the offering price. The board's vote for or against the acquisition will reflect the value of the deal to the corporation as a whole. Suppose, however, that one of the directors is the owner of the asset. If the deal goes through, is it because it is efficient or because the director influenced the vote in her favor? Clearly, there is a good chance that the transaction will benefit the director, while harming the corporation. Indeed, the risk that the corporation will be harmed increases relative to the number of shares the director holds in the corporation. This

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36 *See* Williams v. Geier, 671 A.2d 1368 (Del. 1996).
37 Suppose a controlling owner holds 30 of 100 shares and the rest of the shares are widely distributed. Before the change, the public's voting power is 70%, whereas afterwards, assuming that the public's shares are actively traded, its voting power will sink to 19% (70 votes out of 370) and the controlling owner will have 81% of the vote. In this way, the company may become immune to a potential takeover, without additional investment on the part of the controlling owner.

is because the director—acting as shareholder—also has the power to elect
or remove other corporate officers at a later date.

When the director actually votes on a deal that affects her personally, the
conflict of interests is as clear as it is with the interested shareholder. A more
complicated conflict of interests problem is presented by positional conflicts
of interests. A positional conflict of interests arises when a director acts
to preserve her own position in the company, while her self-serving action
could be construed as promoting a different legitimate motive. For instance,
when resisting a takeover, directors could be guarding their own positions
or protecting the corporation against exploitation or looting. Indeed, it is
hard to ascertain which motive is the true one standing behind the action.

In sum, conflict of interests voting distorts the voting mechanism's ability
to reflect group preference, as the majority view no longer represents the
"correct" choice for the group.

Significantly, not every conflict of interests is necessarily inefficient, and
in certain situations, a transaction with an interested shareholder may be
the best option available to the group. This could be so, for instance, where
the corporation seeks a loan from one of its controlling owners. Because
the rate of interest is, *inter alia*, a function of the amount of information
the lender has regarding the corporation's financial stability, an insider will
be in a better position to offer a cheaper loan. After all, presenting an
accurate portrait of the corporation to an outsider might be difficult, whereas
a shareholder/lender has better access to information and better knowledge
as to its reliability. Moreover, in some situations, an important transaction
may be impossible without self-dealing.[38] Similarly, a self-dealer may have
a competitive edge in the market or even an advantage stemming from her
proximity to the group, which ensures that a deal with her is in the group's
best interests. This is the reason that a screening system should be adopted to
promote efficient transactions and frustrate inefficient ones, rather than a per
se prohibition on self-dealing.[39]

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38 *See, e.g.,* Case v. N.Y. Cent. R.R., 204 N.E.2d 643 (N.Y. 1965) (consolidation of
    taxes between the parent company, which suffered losses, and its subsidiary, which
    registered profits, created a tax saving).

39 *See* Goshen, *supra* note 15, *infra* Part III.A.

II. STRATEGIC AND CONFLICT OF INTERESTS VOTING: FRATERNAL TWINS

Strategic voting and conflict of interests voting have more than a little in common; the same set of facts may often be seen as a conflict of interests *and* a strategic voting problem. Reconsider the example in which one bondholder votes strategically against an interest rate decrease proposed by the company. Though she knows that the proposal merits her support, she votes against it anyway. But the bondholder's behavior is no more strategic voting than it is conflict of interests voting. The bondholder, after all, is motivated by a desire to secure a greater percentage of the profit for herself. In short, her interest as a bondholder in what is best for the company conflicts with her interest in making money from the deal personally. Indeed, strategic voting and conflict of interests voting coincide in the sense that acting "strategically" often means being in a conflict of interests.

Beyond the descriptive similarity of strategic voting as conflict of interests voting, there is a practical coincidence between the two. Many events in corporate law present both aspects simultaneously. This is illustrated by the facts of two cases, *Katz v. Oak Industries*[40] and *Williams v. Geier.*[41]

At issue in *Katz* was a tender offer for bonds with protective covenants. Under the terms of the proposed deal, the price offered to the bondholders was above the market price (but lower than par). Moreover, the deal was predicated on two conditions. First, a majority of the preferred bondholders and at least two-thirds of the subordinate bondholders had to consent to the deal. Second, all of the bondholders who accepted the tender offer were required to vote to rescind the protective covenants.

The structure of the *Katz* deal as an exit consent presented the threat that the bondholders would vote strategically.[42] If each bondholder were to value the bonds at their market price, then the success of the tender offer would not be a sign of a distorted vote. However, even under the assumption that all the bondholders value the bonds at a higher price, e.g., at par, the coordination problem would still lead to the success of the tender offer. Although in the latter case, the clear preference of every bondholder would be to receive par value for her bonds, because the individual bondholder does not know how the other bondholders will vote, she is nonetheless forced into a dilemma. If she tenders

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40   508 A.2d 873 (Del. Ch. 1986).
41   671 A.2d 1368 (Del. 1996).
42   For further discussion, see Goshen, *supra* note 14, at 787.

her bonds, she will receive a premium above market value. More important, if she does not tender but a sufficient number of the other bondholders do, she will be left with bonds stripped of their protective covenants. Consequently, her bonds will be worth less than they were before. Thus, due to the coordination problem the bondholder is forced to accept the tender offer in order to avoid a loss. This situation is a clear instance of strategic voting.

In addition to posing a strategic voting problem, however, the exit consent offer also poses a conflict of interests problem. There is no doubt that a conflict of interests problem arises if the corporation (the debtor) buys back its bonds and later on tries to vote with them to strip them of their protective covenants. Indeed, in *Katz*, there was a provision in Oak's trust indenture clearly prohibiting such a vote by the corporation. The "exit consent," therefore, simply circumvents the prohibition on a conflicted vote by the corporation. After all, the bondholders vote to rescind the bonds' protections in order to fulfill a condition of the tender offer. By the time they cast this vote, however, they have already decided to sell their bonds to the corporation (the offeror), and they do not bear the consequences of their damaging vote. On the other hand, once the corporation receives the bonds, it cannot vote due to the contractual prohibition on conflict of interests voting by the corporation. Thus, for all practical purposes, the exiting bondholders are acting as mere agents of the buyer (the corporation). They are voting "just a second" before they tender the bonds—a tender that will trigger the prohibition on the corporation's conflicted vote. Since it is in the buyer's interest to rescind the protective covenants, the vote for rescission is essentially a conflict of interests vote.

Williams v. Geier provides another illustration of the practical link between strategic and conflict of interests voting.[43] At issue in *Geier* was a plan to amend the company's bylaws so that the bearer of each of its shares would be entitled to ten votes instead of one. Under the terms of the amendment, the additional votes would be forfeited if the share were sold, though continuous possession for a three-year period would eventually restore the additional voting power. In order for the amendment to pass, a majority of the shareholders had to approve it. In addition, due to the fact that the suggested change would result in dual-class shares ("10-votes shares" and "1-vote shares"), the vote to change the bylaws was linked to another issue, namely, delisting. According to the stock exchange rules, a reorganization resulting in dual-class shares must be approved by a two-thirds vote or the stock will be delisted. Therefore, if only a simple majority were to approve

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43   671 A.2d 1368 (Del. 1996).

the amendment, the shares would automatically be delisted. Nonetheless, the controlling shareholder informed all other shareholders that he would vote for the amendment. It was clear, therefore, that although the controlling shareholder had the required majority to assure the amendment of the bylaws, he could not vote a sufficient number of shares to prevent delisting. Consequently, other shareholders supported the change, and the two-thirds majority required to avoid delisting was achieved.

The *Geier* plan can be seen from both strategic voting and conflict of interests perspectives. From the vantage point of average short-term shareholders, the amendment was undesirable. After all, it would put them in the minority, denying them voting power that might otherwise allow them to seize a corporate control premium, without any compensation. Despite their preference, however, the structure of the proposal and, more specifically, the link between the amendment and delisting would force them to vote for the amendment. In other words, they would strategically vote in favor of the amendment in order to avoid having the amendment pass by a narrow—rather than two-thirds—majority.

At the same time, *Geier* presents a clear conflict of interests problem. The controlling shareholder who votes on the deal has an interest in long-term holdings. The passage of the amendment would result in his complete control of the company, without any corresponding capital investment or compensation to the public shareholders. Moreover, it is precisely because his tainted vote would assure the change to the bylaws that other shareholders would be pressured to support the decision in order to avoid delisting. Therefore, even if the controlling shareholder's vote were not to be *counted* (as opposed to actually voted) and a "majority of the minority" vote were achieved, there would still be a distorted vote. This is because counting the number of disinterested supporters *after the controlling owner votes* only reflects the minority's attempt to avoid delisting, not its view regarding the desirability of the change in the bylaws. In order to achieve a sincere vote, the controlling owner would have to refrain from voting on both issues or the minority shareholders would have to be informed *ex ante* that the majority votes will not be counted.

In sum, strategic voting can, theoretically, be viewed as conflict of interests voting. More importantly, in practice, aspects of both problems are present in many fact patterns in corporate law.

III. THE NATURE OF THE SOLUTIONS:
PROPERTY AND LIABILITY RULES

The solutions to strategic and conflict of interests voting can be characterized in one of two ways: either as a property rule or as a liability rule.[44] A property rule is an *ex ante* approach to strategic voting and conflict of interests voting, according to which a deal can only be executed with the consent of all the parties involved.[45] A liability rule, on the other hand, is an *ex post* approach under which the transfer or change of an entitlement can be forced upon the owner by anyone willing to pay the objective value of the entitlement as determined by the courts.[46] To illustrate: Under a liability rule, a factory would be permitted to pollute the air so long as the factory owners pay damages to the pollutee. Such a rule would enable the factory owners to compel the factory's neighbors to sell their preference for clean air in exchange for the objectively determined compensation. A property rule, on the other hand, precludes the carrying out of any transaction to which the owner has not consented. Thus, a rule establishing property protection of clean air for the factory's neighbors would enable injured residents to receive a court injunction to stop the pollution. Consequently, the factory would have to buy its neighbors' rights to clean air for a price reflecting their subjective valuation of clean air.

There are two key elements that underlie the property rule-liability rule distinction. The first relates to the method of valuation. Under a property rule, subjective valuation is determinative. All of the parties to the deal determine *ex ante* whether they find the deal to be subjectively worthwhile. In contrast, under a liability rule, objective valuation is the standard. The deal may go through over the objection of some of the parties. At a later stage, however, the court will step in and determine the value of the transaction based on an objective evaluation, compensating those who were in opposition.

A second distinction lies in the division of the surplus. A voluntary transaction generates a surplus, because each of the two parties attaches a different value to the deal. Under a property rule, each party can negotiate freely and attempt to secure a larger share of the surplus for herself. Under a liability rule, however, one party is forced into a transaction and does not negotiate for the surplus at all. Since any division of the surplus reflects an efficient transaction and thus would be determined as objectively fair *ex*

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44 *See* Calabresi & Melamed, *supra* note 3.
45 *See id.* at 1092.
46 *See id.*

post, the party forcing the transaction will most likely secure the larger part of the surplus.

The choice between the rules is based on the balance between negotiation costs attendant upon a property rule and adjudication costs attendant upon a liability rule. In short, negotiation costs will involve such costs as sending proxies, holding the vote, contending with holdouts, and a reduced number of efficient transactions; adjudication costs will include litigation and time costs, receipt and evaluation of expert valuations, and judgment errors. These costs, in turn, will depend on the specifics of the conditions of the economy and the legal system in the given country.[47] Therefore, the question whether one rule is preferable to the other or the two are equally effective will be determined by the realities of the given country. Below, I suggest some guidelines for choosing between a property rule and a liability rule to address strategic voting and conflict of interests voting.

A. Strategic Voting

Some of corporate law's solutions to strategic voting can be characterized as property-rule protections and others as liability-rule protections. Consider restrictions on coercive voting.[48] These restrictions allow security holders to arrive at the group preference by forcing people who wish to transact with the group to acquire its consent. These restrictions afford the security holders property-rule type protection: transactions are invalid *ex ante* if the rights of the security holders are not protected up front. Moreover, the valuation here is subjective. Since the transaction is voluntary, the security holders determine whether or not the deal is worthwhile. Likewise, because the security holders have the power to thwart the transaction, they can negotiate for a greater portion of the surplus. In all senses, then, restrictions on coercive voting offer property-rule protection.

In stark contrast, whenever coercive voting is allowed,[49] liability-rule protection is—or at least should be—afforded. With coercive voting, the

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47   *See, e.g.*, Bernard Black & Reinier Kraakman, *A Self Enforcing Model of Corporate Law*, 109 Harv. L. Rev. 1911 (1996) (discussing the situation in Russia); Goshen, *supra* note 15.

48   For such a proposal in the context of hostile takeovers, see Lucian Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 Harv. L. Rev. 1695 (1985).

49   For such a proposal in the context of hostile takeovers, see Frank Easterbrook & Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161 (1981).

group of voters is unable to present its true preference in the vote, since it is *forced to consent*. Practically, therefore, the deal is not a consensual one. As there is no need for true consent *ex ante*, security holders should have the right to ask the court to determine the value of the transaction *ex post*. In other words, since the security holders are forced to accept the deal, they should have the right to objective valuation. Because the standard is objective and the valuation is conducted after the transaction has been completed, the minority holders have very weak bargaining power and thus, *ex ante*, will receive a small portion of the surplus. For these reasons, allowing coercive voting results in a legal regime that provides liability-rule protection. In practice, however, courts have not provided for the right to ask for *ex post* valuation.[50] Any offer above market price is considered *fair* in the context of strategic voting.

B. Conflict of Interests Voting

The characterization of the solutions to the conflict of interests problem as either a property rule or liability rule is based on both the type of valuation that each rule applies and the ramifications of each rule's distributive effect. Contrast in this respect the "fairness"[51] and the "majority of the minority"[52] solutions. The fairness test assumes that the majority can force a transaction upon the minority, provided that the majority ensures a fair price that can be verified *ex post*. Put another way, the fairness rule establishes a regime of involuntary transactions and thus replaces the subjective valuations of the contending security holders with an objective measure of valuation. For this reason, it is a liability rule.

The "majority of the minority" test, on the other hand, prevents the self-dealer from voting, thereby leaving the decision whether to accept the transaction in the hands of the disinterested minority. The group (this time represented by the disinterested minority) is free to accept or reject the deal based on its subjective valuation. This rule, in short, provides *ex ante* protection to the security holders and is thus property-rule protection.

The "fairness test" and the "majority of the minority" rule likewise differ in terms of how they affect the division of the surplus. Under the fairness test, the surplus is divided in the majority's favor. So long as the price

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50 *See* Goshen, *supra* note 14.
51 *See* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
52 This is, for instance, the rule in Canada; *see* Ronald J. Daniels & Jeffrey G. Macintosh, *Toward a Distinctive Canadian Corporate Law*, 29 Osgoode Hall L.J. 863, 929 (1991).

offered by the majority is within the range of efficient prices—a price that could be determined in a transaction between a willing buyer and a willing seller—the transaction will be approved by the court.[53] Thus, the majority can give a low but efficient price, taking most of the surplus for itself. In contrast, the "majority of the minority" rule favors the minority in the division of the surplus: since the minority wields a great deal of negotiating power *ex ante*, it can secure a greater portion of the surplus for itself. Indeed, if it is not satisfied with its part of the surplus, the minority can thwart the transaction entirely by voting against it.[54]

As stated above, in both types of insincere voting, the superiority (or neutrality) of one rule over the other depends on the amount of negotiation costs attendant upon a property rule relative to the adjudication costs attendant upon a liability rule. The preference of one rule over the other thus is a function of the realities in the given country.

SUMMARY

Voting lies at the center of collective decision-making in corporate law. While scholars have identified various problems with the voting mechanism, insincere voting—in the forms of strategic voting and conflict of interests voting—is perhaps the most fundamental. As shown in this article, insincere voting distorts the voting mechanism at its core, undermining its ability to determine transaction efficiency. As further demonstrated, strategic voting and conflict of interests problems frequently coincide with one another: voting strategically often means being in conflict, and many fact patterns pose aspects of both problems. Although the two problems have seemingly different solutions, these solutions are essentially similar in nature: all solutions to insincere voting are variations on two basic rules, namely, property and liability rules.

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53 *See, e.g.*, Revised Model Bus. Corp. Act § 8.61 note on fair transactions (1989) ("It has long been settled that a 'fair' price is any price in that broad range which an unrelated party might have been willing to pay or willing to accept, as the case may be, for the property, following a normal arm's-length business negotiation, in the light of knowledge that would have been reasonably acquired in the course of such negotiations, any result within that range being 'fair'... .").

54 *See* Susan Rose-Ackerman, *I'd Rather Be Liable Than You: A Note on Property Rules and Liability Rules*, 6 Int'l Rev. L. & Econ. 225 (1986); David D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 Va. L. Rev. 701, 707 (1987).