Hedge Funds’ Empty Voting In Mergers And Acquisitions: A Fiduciary Duties Perspective

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The aim of this Article is twofold. On the one hand, I address the impact of hedge funds’ activism on the financial markets and on the portfolio companies. In general terms, hedge funds’ activism should be seen as a neutral element. After a cost-benefit analysis, I show that the costs implied by hedge funds’ activism are at least offset by the relevant benefits. Data reported by recent empirical studies seem to back this conclusion. However, when empty voting is used, a potential risk of incentives distortion arises, particularly when empty voting is coupled with a conflicted position of the hedge fund which stands on both sides of the transaction, as illustrated by the famous King-Mylan case. In addition, I show with a numerical example that under certain circumstances empty voting is likely cause and/or facilitate value-destroying (inefficient) mergers.

On the other hand, the Article pursues a policy approach. I do not present ad hoc policy measures based either on disclosure or voting abstention proposals, as already done in literature. Rather, I frame empty voting used in merger and acquisition transactions within the current Delaware corporate law standards of review. I indeed propose a functional approach based on the fiduciary duties doctrine which is applicable to empty voting regardless of the technical device employed. It endorses the direct involvement of the disinterested shareholders (i.e. the shareholders other than the empty voters) and posits that an approval of the transaction by the majority of disinterested shareholders should trigger a business judgment presumption.

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I. INTRODUCTION

Hedge funds (hereafter “HFs”) have been traditionally playing a strong financial role but lately have become extremely active also in the mergers and acquisitions (hereafter “m&a”) arena. Their active involvement has been propelled by a tactic allowing them to decouple voting rights from economic ownership and labelled in the literature as “encumbered shares” or “empty voting.”1 The tactic can be implemented in multiple fashion through the employment of several different financial engineering contracts (derivatives, short selling, swap, vote buying and borrowing/lending) final common outcome of which is to lay off the economic risk associated with a shareholder position.

There are several examples of HF intervention in m&a transactions. In this paper, I will refer to the King-Mylan Laboratories acquisition (hereafter “King-Mylan”) as a template transaction to show the possible operating extremes reached by the HFs in the mergers and acquisitions area when empty voting is involved. The King-Mylan merger is peculiar in that the recourse to empty voting has been coupled with a conflicted position of the HF, which was holding stock of both the acquiring and the target company.

In that case, “Perry Corp., a hedge fund, owned seven million shares of King Pharmaceuticals. Mylan Laboratories agreed in late 2004 to buy King in a stock-for-stock merger at a substantial premium. However, Mylan’s shares dropped sharply when the deal was announced. To help Mylan obtain shareholder approval for the merger, Perry bought 9.9% of Mylan – becoming Mylan’s largest shareholder – but fully hedged the market risk associated with the Mylan shares. Perry thus had 9.9% voting ownership of Mylan but zero economic ownership. Including its position in King, Perry’s overall economic interest in Mylan was negative.”2

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2 Hu & Black, The New Vote Buying, supra note 1, at 826. A situation that is comparable with the King-Milan case is reported in Henry T.C. Hu and Bernard S. Black, Equity and Debt Decoupling and Empty Voting II: Importance and Extentions, 156 U. PA. L. REV. 625, 634 (2008) [hereinafter
The approach of the paper is twofold. In the first part, the paper has a broad and conceptual vision. In this perspective, I will address the impact of HF activism on the financial markets and on the portfolio companies, as propelled by the empty voting technique. The HFs (and in general any other financial player) can employ the empty voting tactic in two ways. Empty voting can simply have a financial “color”, in the sense that the HF can use financial engineering contracts related to its position of shareholder to amplify, reduce or nullify economic interests (or even to get an economic interest counter to that of the fellow shareholders, hereafter referred to as “negative economic ownership”). However, more interestingly for our analysis, it can also have a governance “color”, in the sense that the HF can use financial engineering contracts to play an activist role in m&a transactions. In these circumstances, empty voting can help the HF to take substantial positions on the defensive side as well as on the offensive side of the transaction, either to block or to determine the success of an acquisition. Whereas, in general terms, HF activism should be seen as a neutral element, empty voting carries the potential risk of incentives distortion, particularly when it is coupled with a conflicted position of the HF, as illustrated by the King-Mylan case. In addition, empty voting coupled with negative economic ownership by the HF is likely to cause and/or facilitate value-destroying (inefficient) mergers, as shown by the numerical example in Section III.C infra.

In the second part, the paper pursues a policy approach. The analysis will not be focused on ad hoc policy measures based either on disclosure or voting abstention proposals, as already done in literature. Rather, a functional approach based on the existing fiduciary duties doctrine will be advanced to tackle empty voting, regardless of the technical device employed. In view of this, I will frame the interplay between HF activism and empty voting into the current Delaware corporate case law, to investigate the possible influence of the HFs (and their financial power) on the target and/or acquiring companies and their management and to show that conflicts of interests may arise in case of recourse to empty voting. The current Delaware law mandates the entire fairness (EF) standard of review for conflicted transactions, with a shift in the burden of proof on the plaintiff, should the board of directors have obtained the approval of the deal by either the majority of minority shareholders (“MOM” approval) or an independent special committee (“ISC” approval).

In m&a transactions in which shareholders (HFs) employ empty voting, Delaware courts – the most likely venues where these transactions will be litigated – should not rule empty voting as unlawful per se. However, on the ground of incentives distortion, inefficiency and conflict of interest concerns arising from empty voting, those transactions should be approved by a majority of disinterested shareholders (MOM requirement) and scrutinized using a fiduciary duty perspective. For these purposes, the application of the current m&a standards of review should be adjusted to develop a “disinterested shareholders’ approach”, under which the law would provide directors with incentives for seeking the

Hu & Black, Empty Voting II] (describing the March 2006 offer by the Delaware company Multi-Fineline Electronix to buy the Singapore company MFS Technologies) and in Thompson & Edelman, supra note 1, at 31 note 140 (describing the AXA-Mony case: “Another instance in which the shareholders of the acquirer had an incentive to vote in a way opposite to the financial interest of the company was a transaction involving AXA and Mony”) (footnotes omitted).
approval of the transaction by the majority of disinterested shareholders. In this regard, on the one hand, in case of a controlling shareholder (i.e., a shareholder with a material influence on the board of directors and/or on a specific transaction) who employs empty voting, an approval of the transaction by the majority of disinterested shareholders – the actual residual claimants when empty voting is used – should trigger a business judgment presumption. Without MOM approval, entire fairness would be the standard of review. On the other hand, in case of a “swing vote” shareholder (i.e., a shareholder having an outcome-determinative position with respect to a specific transaction but no influence over the board of directors), an approval of the transaction by the majority of disinterested shareholders should also trigger a business judgment presumption. Without MOM approval, however, I propose the application of the business judgment standard with a flip in the burden of proof on the defendant, as discussed in detail in Section IV.E infra.

The paper is structured as follows. Part II will develop a cost-benefit analysis of the HF activism to ascertain whether, as a general matter, HF activity should be restricted or sustained. Part III will describe the incentives distortion created by the financial engineering contracts leading to empty voting, in particular when coupled with shareholders’ conflicted positions. The possible negative influence of empty voting will be considered, suggesting that accomplishment of value-destroying (inefficient) mergers would be more likely under recourse to empty voting. A numerical example will show the case. After a brief survey of policy measures already advanced in literature, Part IV will focus on the fiduciary duties approach to empty voting and develop the application of the current fiduciary duties standards of the company’s directors and controlling shareholders to conflicted transactions involving empty voting. Different scenarios will be addressed, depending on the position assumed by the HF, whether as controlling or swing-vote shareholder. Part V will draw some preliminary conclusions and mention a final caveat.

II. COSTS AND BENEFITS OF HEDGE FUNDS’ ACTIVISM

Statutory rules do not provide a definition of “hedge fund” at either federal or state level. Business practice in the past few years, however, has witnessed the outstanding rise of the HF sector, amounting nowadays to a trillion dollars industry. HFs are sophisticated financial intermediaries, pursuing investment strategies, focused on several and differentiated capital markets (currencies, commodities, derivatives, equity, debt). The industry is also lightly regulated, being de facto exempted from the fundamental provisions of the Securities Act of 1933, the Investment Company Act of 1940, and the Securities Exchange Act of 1944. Even if the SEC, with a highly debated regulatory move in 2004, required the HF managers to register under the Investments Advisers Act of

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1940, the HFs are also exempted from the provisions of the Investments Advisers Act of 1940 after a 2006 federal appellate court decision to vacate the rule.\(^4\)

From a legal perspective, HFs have grown as investment funds structured to fill the loophole of the federal securities law, rather than as a constituency expressly exempted from federal regulation. From an economic perspective, for these reasons, HFs may enjoy features that other registered investment intermediaries cannot employ in their investment decisions. First, HFs may employ a high leverage ratio that is generally far higher than the ratio used by regulated investments vehicles.\(^5\) Secondly, HFs have the possibility to sell short, taking positions against the market.\(^6\) Finally, in general terms, HFs can invest in illiquid assets to an extent greater than the other funds.\(^7\)

These features explain why HFs have traditionally played a strong financial role and why they make investment decisions that are often based on short-termism and selling-short strategy, thus basically betting against the market. Their investment strategy and the amount and size of their transactions, however, are likely to contribute to the liquidity of the market and enhance the informational efficiency. Because of this intrinsic financial-player nature, HFs have not been historically interested in governance matters. Their recent involvement in several m&a operations, either on the acquirer or on the target side, have raised critical concerns even bigger than those related to their financial role. Thus, the threat might have shifted from the integrity of the market as a whole to the integrity of some specific constituencies involved in m&a transactions, namely, the shareholders of either the acquiring or the target company. The reasons for their increased interest in the governance decisions of the portfolio companies are not easy to find. Some scholars have recently analyzed this new environment and have found sound financial reasons for their governance involvement.\(^8\)

I will not discuss whether or not HFs have the right incentives to perform a strong governance oversight activity, where all other actors have, in the past, failed. Rather, I will briefly report the costs and benefits generated by the HFs’ activism and show how benefits seem to overcome costs, or at least offset them. On these grounds, in general terms, HF activism should not be restricted because it might have some beneficial influence on the governance decisions taken by the portfolio companies. With this perspective, to the extent the recourse to financial engineering contracts leading to empty voting helps the HF to perform a benefic oversight activity, these techniques should not be seen disfavorably, provided some balances are in place, as discussed hereafter.

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\(^4\) See Goldstein v. SEC, 451 F.3d 873, 877 (U.S. App. D.C. 2006) (which “held that hedge fund rule requiring that investors in a hedge fund be counted as clients of the fund’s adviser for purposes of fewer-than-fifteen-clients exemption from registration under IAA was invalid as conflicting with purposes underlying the statute”).

\(^5\) Kahan & Rock, supra note 1, at 1062 (reporting that “15% of hedge funds use a leverage ratio in excess of 2”; citing industry sources). See also Frank S. Partnoy & Randall S. Thomas, Gap Filling, Hedge Funds, and Financial Innovation, available at http:\/\/ssrn.com/abstract=931254.

\(^6\) See Partnoy & Thomas, supra note 5, at 29.

\(^7\) Kahan & Rock, supra note 1, at 1063 (pointing out that “[c]ontractually, hedge fund investors have more limited withdrawal rights than mutual fund investors”).

\(^8\) Thompson, supra note 1, passim; Paredes, supra note 3, at 982 note 27; Kahan & Rock, supra note 1, at 1069 (arguing that “(activist) hedge funds pursue activism as a profit-making strategy”).
A. Costs of Hedge Funds’ Activism

From a cost-benefit analysis viewpoint, the HF activity involves three costs, consisting of: (i) systematic risk, (ii) adverse selection for lack of disclosure, and (iii) ownership agency costs.

On the grounds of their strong financial role on different markets, the HFs’ peculiarities, consisting of high leverage and selling short, exacerbate systemic risk and create a negative externality. This is due primarily to two reasons. HFs are not required to meet the same capital adequacy standards that mutual funds are required to meet, so that a loss might have a more critical impact on their survival. In addition, notwithstanding their definition as “hedge” funds, they may choose to sell short, not just to hedge long positions, but to leverage the bet in one direction, thus increasing the size of the potential loss. The occurrence of astonishingly high losses recorded even in a short timeframe demonstrates the highly volatile and risky nature of the industry. However, past and important debacles in the sector, such as the Long-Term Capital Management (LTCM) crisis, have not posed a systemic risk, but rather a credible threat to the investment integrity of the fund investors, in that case mostly consisting of investment professionals. Further, from a policy perspective, neither the SEC nor the (Delaware) courts can regulate this peculiar area of the HF industry; only the Federal Reserve System and the Treasury Department are empowered to do so.

The second cost is related to the opaque nature of the HF sector and to the de facto exemption from mandatory disclosure provisions. The exemption from the bulk of the federal securities law creates an area where HFs have basically no disclosure requirements. The capital markets are notoriously characterized by informational asymmetries between issuers and the public investors and, more interestingly for this point, also between intermediaries and the public investors. In addition, capital markets are characterized, absent any regulation, by an undersupply of information from intermediaries to the public investors. Without mandatory disclosure obligations, the HF area is tainted by these informational deficiencies. In these situations, adverse selection problems could arise to the extent that HFs that had poor performance records or, even worse, that had engaged in fraudulent or illegal conduct might be selected to the detriment of “better” HF. However, it is interesting to note that these costs are lower in this sector than in other industries. The problem is moderated by the nature of the HF investors, who are themselves sophisticated investors—often institutional investors, as demonstrated by the LTCM case—and who perform lengthy due-diligence process to select the HF.


11 Paredes supra note 3, at 992-996. The SEC 2004 regulatory decision requiring the HF managers to register under the Investment Advisers had slightly changed this background, eliminating a positive signalling feature for those HFs that voluntarily registered when not required. Despite this
The third cost is an “ownership agency cost” (private benefits of control). By ownership agency cost, I refer to the costs involved in the change of the company ownership structure caused by the HF activity. As also the King-Mylan operation shows, the HFs have increasingly taken influential or even dominating stakes in portfolio companies.\(^\text{12}\) The ownership structure of the company then turns from dispersed ownership to concentrated ownership, and one major consequence of this structural change consists in the tradeoff of the different agency costs involved in the two structures. Both concentrated ownership and dispersed ownership structures face different agency costs, but concentrated ownership companies are allegedly tainted by higher agency costs than are dispersed ownership companies.\(^\text{13}\) Therefore, the HF governance activity could be interpreted as increasing the overall agency costs in the companies in which it takes a controlling stake. This conclusion is however arguable for a number of reasons. First, dispersed ownership companies also show severe agency costs, some even more acute due to collective behavior problems suffered by dispersed shareholders.\(^\text{14}\) Secondly, these agency costs are likely to emerge not immediately after the HF intervention, but rather in the long term: some governance actions by the HF need to take place before the agency costs arise. Finally, these agency costs are likely to be offset by the governance benefits created by the HF in its quality of “shareholder activist”, which are discussed hereafter.

### B. Benefits of Hedge Funds’ Activism

Turning now to the positive side, the benefits created by HF activism include (i) liquidity benefits, (ii) market efficiency benefits, and (iii) corporate governance benefits.

Liquidity benefits are incontestable and derive from the huge amount of trading activity supplied by the HFs. Recent evidence has shown that HFs’ impact on capital markets has mounted to a staggering 40 to 50% of the daily trading activity in major equity markets and to “over 70% of daily trading activity in the

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\(^{12}\) For empirical data on HFs’ strategy in taking significant stakes in portfolio companies, see April Klein and Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, (ECGI – Fin. Working Paper No. 140. 2006), available at http://ssrn.com/abstract_id=913362, at 1 and 4 (defining “hedge fund activism as a strategy in which a hedge fund purchases a 5 percent or greater stake in a publicly-traded firm with the stated intent of influencing the firm’s policies” and documenting “a 60% success rate for all demands made in the initial 13D filings”); see also William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375 (2007).

\(^{13}\) Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An Int’l Comparison*, 59 J. Fin. 537 (2004) (empirically finding that in countries where private benefits of control are larger and capital markets are less developed, ownership is more concentrated).

\(^{14}\) A recent and famous example of an agency problem which affected extensively dispersed ownership companies, in particular U.S. corporations, has been executive compensation: see LUCIAN BEBCHUK & JESSE FRIED, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press 2004) (arguing that executive remuneration – if set at incredibly high levels – may be considered an agency cost *per se*).
convertibles market, the U.S. distressed debt market and the U.S. exchange-traded fund market%^15^.

As to market efficiency benefits, HFs perform basically two beneficial activities on the markets. First, HFs make returns on investments anticipating market moves, basically performing an arbitrage activity. This activity generates a reduction in the spread between the actual price and the perfect price on the market, thus improving market efficiency. A second positive feature is related to the signalling function of HF investments decisions. Here, the decision by an HF to invest in a particular company may be interpreted in different ways, namely as a positive or negative signal to fellow investors. On the one hand, the HF may invest in a particular company either because that company has had a good economic performance or because that same company is simply undervalued; on the other hand, the HF may exit because the company has performed poorly or because it can cash out a nice profit. In any case, the HF investment decisions have a strong signalling power and help the markets’ informational efficiency; in particular, empirical evidence seems to suggest that HFs, unlike previous blockholder activists, tend to target companies with good performance and high cash flow.\(^^\text{16}\) Eventually, HFs may exercise a strong governance role. They have the economic power, and allegedly the economic incentives, to influence corporate governance decisions and discipline the management (or at least threaten to do so). So, there is a widely accepted optimistic idea that HFs can be beneficial to the portfolio companies. The HFs have so far intervened in different areas. In m&a transactions, they have monitored either the acquirer’s management desire of empire building or the conflicts of interests in freeze out operations; outside the m&a area, they have made contributions to change business plans or pushed for cash payments to shareholders (including themselves) or again improved the management’s oversight obtaining board seats.\(^^\text{17}\) Finally, HFs generally target companies with high cash flow and low debt exposure. After the HF intervention, the same companies turn out to be highly leveraged and their management more

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\(^{15}\) See Paredes, supra note 3, at 986 note 19. See also Partnoy & Thomas, supra note 5, at 30 (reporting that “hedge funds trade more frequently than other institutional investors and account for roughly half of trading on stock exchanges”).

\(^{16}\) For a general overview on the signalling function, see Michael Spence, Signalling in Retrospect and the Informational Structure of Markets, AM. ECON. REV., June 2002, at 434.


\(^{18}\) See Thompson, supra note 1, at 14-18 (investigating these very features) and at 36 (suggesting that “for many hedge funds, their self-chosen businesses plans are better aligned with what is necessary for provid[ing] successful shareholder discipline of management”); see also Kahan & Rock, supra note 1, at 1022 (arguing that the problems raised by the HF activity in corporate governance and corporate control “are relatively isolated and narrow, do not broadly undermine the value of hedge fund activism as a whole, and do not warrant major additional regulatory interventions”).
restrained in its potential activity. Therefore, HF activism is beneficial as it reduces the agency costs related to free cash flows.\footnote{Klein and Zur, supra note 12, at 22 (citing the position of Harvard Business School’s Professor Michael C. Jensen).}

In view of this, HF activism benefits seem to overcome the relevant costs, or at least to offset them. Therefore, this cost-benefit analysis makes a first case for empowering and enhancing the HF activism, or at least for not restraining it. However, as the King-Mylan transaction has shown, the employment of financial engineering contracts (which may result in empty voting) is an important feature in the HF activist strategy. The King-Mylan deal also demonstrates that this tactic has not been used as stand-alone strategy, but it is often coupled with other strategic decisions, in particular with the simultaneous presence of the HF as shareholder on both sides of the transaction. This coupling feature raises, instead, delicate concerns about the protection of the parties involved in the transaction, with particular emphasis on fellow shareholders. Concerns are heightened when the HF has distorted incentives and owns a \textit{de jure or de facto} controlling position in the transaction (for example, in the King-Mylan transaction, the hedge fund Perry Corp. with a 9.9\% stake became the largest shareholder of the acquiring company).

Aware of this tradeoff between possible benefits and possible threats to specific corporate constituencies, the Delaware courts should exercise caution in handling this legal technique. However, they should not rule it unlawful \textit{per se}. Doing so would be a draconian policy measure not backed by a cost-benefit analysis and might have a strong negative effect on the HF beneficial activism. Rather, the Delaware courts should focus their scrutiny on any distorted incentives and any conflict of interest raised by these coupling and offer incentives for the involvement of the real residual claimants – the fellow (disinterested) shareholders – in the critical decisions. Sections IV.D and IV.E \textit{infra} elaborate on this matter.

III. \textbf{FINANCIAL ENGINEERING CONTRACTS: INCENTIVES DISTORTION ON THE OFFENSIVE AND DEFENSIVE SIDES AND INEFFICIENT TRANSACTIONS}

A. Setting the Stage: Incentives Distortion

In this Section, I will not discuss all the financial devices (share borrowing/lending or selling, put/call options, short positions or other financial derivatives) possibly used by the HF to hedge the economic risk related to his shareholder position, as some other scholars have accurately already done.\footnote{See Martin & Partnoy, supra note 1, at 788-792 (reporting seven examples of “economically encumbered” shares). Many technical devices are also reported by Hu & Black, \textit{The New Vote Buying}, supra note 1, Table 1 at 827 and Hu & Black, \textit{Empty Voting II}, supra note 2, Table 1 at 661-681.} I will rather sketch the incentives distortion faced by the HF (and any other player) in three different scenarios:
(i) the HF takes a conflicted shareholder position by holding shares of both the acquiring and the target company;
(ii) the HF only holds shares of one company but it lays off (partially or totally) the related economic risk by virtue of financial engineering contracts;
(iii) the HF takes a conflicted shareholder position by holding shares of both the acquiring and the target companies and it lays off (totally or partially) the economic risk related to the acquirer company (a situation similar to the King-Mylan transaction).

I will also show that when empty voting is employed by a shareholder standing on both sides of the transaction, as under (iii) above, that shareholder enjoys the strategic advantage of being able to take substantial stakes in both companies, giving the shareholder a stronger decision power.

To better understand the three different scenarios, take the standard m&a transaction with a target (T) company and an acquiring (A) company. Suppose both companies have 100 shares outstanding and they trade both at $1, which in efficient markets is the value per share (V) of the companies. Suppose further that T is acquired by A at a price per share (P) and that the HF holds x% shares in T and y% shares in A. Absent any synergies or other benefits from the merger (i.e., assuming that the merger is neutral from an efficiency perspective), the HF payoff or economic interest (S) is given by the following formula:

\[ S = x(P-V) + y(V-P) \]  

The price P may be equal to, higher or lower than V ($1). If the price P equals V (P=V), the price paid is by definition “fair”; if the price P is higher than V (P>V), the target shares have been overpaid; if P is lower than V (P<V), the target shares have been underpaid.\(^{21}\)

In any of the three scenarios (i), (ii) and (iii), if we consider that synergies are equal to zero, the transaction involves only distributive aspects. Thus, if a fair price is paid (i.e., P=V) for the merger, the HF and any shareholder would be economically indifferent with respect to their position in the target and acquiring company. In other words, if a fair price is paid, the HF could indifferently hold shares only in the T, or only in the A. Moreover, if the HF held shares both in T and A, it could indifferently hold the same share of stock in T and A, a larger share of stock in T than in A or, conversely, a larger share of stock in A than in T.\(^{22}\)

Consider now the overpayment and underpayment situations.

In the first scenario (i), the HF holds shares both in T and in A, but it bears all the risk related to these stakes. This is a classic self-dealing or conflicted transaction in the sense that the HF has opposite economic interests.\(^{23}\) In case of

\(^{21}\) The same reasoning applies also to stock-for-stock mergers or tender offers, as the price that the acquiring company is willing to pay, can influence the exchange ratio.

\(^{22}\) In the formula \( S = x(P-V) + y(V-P) \), if \( P=V \), the outcome of both parts of the formula will be zero, regardless of the values of x and y.

\(^{23}\) See, in similar terms, Henry T.C. Hu & Bernard S. Black, Hedge Funds, Insiders, & the Decoupling of Economic & Voting Ownership: Empty Voting and Hidden (Morphable) Ownership, 13 J. CORP. FIN. 343 (2007) [hereinafter Hu & Black, Empty Voting (Finance Version)], at 353 ("[a]n economic interest in both sides to a prospective merger can, depending on one’s relative positions in acquirer and target, create a variety of incentives that differ from those
overpayment (i.e., when $P>V$), the HF will have an incentive to hold more shares in the target company than in the acquiring company ($x>y$); in particular, it will maximize its interest taking a stake as large as possible in the target company and as small as possible in the acquirer.\textsuperscript{24} In case of underpayment (i.e., when $P<V$) the HF will have an incentive to hold more shares in the acquiring company than in the target company ($y>x$) and it will maximize its interest taking a stake as large as possible in the acquirer company and as small as possible in the target.\textsuperscript{25}

In the second scenario (ii), the HF holds shares only in one company and hedges partially or totally the related risk, so that voting rights are higher than economic ownership.\textsuperscript{26} Whereas the one-share-one-vote principle is a mandate for economic risk proportional to the voting power, the decoupling creates a disproportion between voting power and economic risk causing the final outcome to be similar to the situation created by a deviation from the one-share-one-vote standard.\textsuperscript{27} When the economic risk is totally hedged, the HF will be indifferent to an increase or a decrease in the share price and it will be also indifferent, in m&a transactions, to overpayment or underpayment by the target company. Accordingly, when the economic risk is partially hedged, the HF will have, depending on the financial engineering contracts entered into, positive or negative economic ownership; in the former situation, it would benefit from an increase in the price of the shares, whereas in the latter, it would benefit from a price drop.\textsuperscript{28}

In the third and last scenario (iii), the HF holds shares both in $T$ and in $A$ and hedges partially or totally the risk related to one (both) company (companies). Here the major feature is the match of a conflicted shareholder position with the employment of hedging financial engineering contracts. This situation is of particular interest, because the HF might play either on the offensive or on the of other investors. [...] An investor who holds long positions in both companies but a larger position in the target (acquirer) will favor a merger on terms favorable to the target (acquirer)”).

\textsuperscript{24} Suppose as in the template example that $V=1$ and further suppose that $P=2$, the HF will maximize $S$ when $x=100$ and $y=0$. In that case, $S = 100 (2-1) + 0 (1-2)$.

\textsuperscript{25} Suppose as in the template example that $V=1$ and further suppose that $P=0.5$, the HF will maximize $S$ when $x=0$ and $y=100$. In that case, $S = 0 (0.5-1) + 100 (1-0.5)$

\textsuperscript{26} From a purely “voting” perspective, empty voting is basically a deviation from the principle of one-share-one-vote. On these grounds, it might be argued that, from this perspective, HF is who use empty voting should be allowed to vote in the same way that fellow shareholders are allowed to use several devices ending up in a deviation from the one-share-one-vote principle (e.g., dual class capitalization, pyramid structures or cross-ownership). However, empty voting could be distinguished at least from a specific deviation device, namely a recapitalization into a dual class structure, because empty voting constitutes an unexpected recapitalization that cannot be avoided by fellow shareholders. This profile makes empty voting more problematic than traditional dual class recapitalization. I thank Prof. Jesse Fried for helpful suggestions on this point.

\textsuperscript{27} See Thompson, supra note 1, at 33 (arguing that it creates a separation between ownership and control and defining this situation as “shell voting”). As noted before, Hu & Black, The New Vote Buying, supra note 1, at 825, define this specific result as “empty voting” (voting rights exceeding “net economic ownership”); Martin & Partnoy, supra note 1, at 787, speak instead about “economically encumbered” shares.

\textsuperscript{28} Martin & Partnoy supra note 1, at 788-792, analyze seven hypotheses of financial engineering contracts that make the HF economically interested in an increase or a decrease of the share price. Overall negative economic ownership is easy to reach, even without standing on both sides of a transaction; Id. at 778-779 (“Even a shareholder who owns a single share and simultaneously holds a ten-share short position retains a vote, even though her net economic interest is directly counter to that of other shareholders”). This situation is different to that here at stake because it implies an investment only in one company and not in both the acquirer and the target.
defensive side, depending on whether it decouples the economic ownership from the voting rights in the acquiring or the target company. For reasons of clarity, the following example will address a total hedging, either in the target or in the acquiring company.

**HF on the defensive side.** Consider first the HF playing on the defensive side, holding shares in both T and A and hedging totally the risk related to T shares. Thus, with respect to its position in T, the HF is indifferent as to the price/payment received by T (same situation as in the second scenario); with respect to its position in A (i.e., as shareholder of the acquirer), the HF will have an incentive to underpayment, as by default in every acquisition on the acquirer side; however, and this is the main distortion created by the empty voting, with respect to the number of shares held in T, now the HF will have an incentive to take a substantial position also in T (target) and will be even able to hold more shares in T than in A (x>y). Under a traditional conflicted shareholder position without hedging (the first scenario), “in case of underpayment (i.e., when P<V), the HF will have interest to hold more shares in the acquiring company than in the target company (y>x) …”.

**HF on the offensive side.** Consider now the HF playing on the offensive side, holding shares in both T and A, but hedging totally the related risk to the acquiring company (A). Thus, with respect to its position in A, the HF is indifferent as to the price/payment paid by A (same situation as in the second scenario); with respect to its position in T (i.e., as shareholder of the target), the HF will have an economic interest to an overpayment, as by default in every acquisition transaction on the target side; however, and this is the main distortion created by the empty voting in A (acquirer), with respect to the number of shares held in A, now the HF will have an incentive to take a substantial position also in A and even be able to hold more shares in A than in T (y>x), whereas under a traditional conflicted shareholder position without hedging (our first scenario), “in case of overpayment (P>V), the HF will have interest to hold more shares in the target company than in the acquiring company (x>y) …”.

29 The King-Mylan merger is a situation where the employment of financial engineering contracts has been used also on the target side with veteran activist Carl Icahn present. There, actually, in an effort to prevent the merger, Carl Icahn did not hedge totally the economic risk related to his position in King (the target company), but even shorted his position while he was also standing with a substantial stake on the acquirer side. See Kahan & Rock, supra note 1, at 41 note 222 (“Icahn had a stake of about 10% in Mylan, both in terms of economic exposure and in terms of voting rights. But Icahn also had a shorted 5.3 million shares of King stock”).

30 Mathematically, the formula $S = x (P-V) + y (V-P)$ is affected by the hedging of economic risk in T in that the HF will enter into a derivative contract yielding an amount equal to x (V-P) (or, -x (P-V)), so that the first part of the formula is always equal to zero, regardless of the price (P) paid.

31 Kahan & Rock, supra note 1, at 1075 (reporting that in the King-Mylan case, Perry “apparently entered into equity swaps with Bear Sterns and Goldman Sachs that fully hedged its economic exposure to Mylan’s share price”).

32 For a similar example, see Hu & Black, Empty Voting (Finance Version), supra note 23, at 353 (“For example, a merger arbitrageur who follows the classic arbitrage strategy of going long target - short acquirer would have an incentive to support a merger, even if it was bad for the acquirer or the combined firms”).

33 Hu & Black, The New Vote Buying, supra note 1, at 825 (defining the conflicted position in T as a “related non-host asset”).

34 Here in parallel, the formula $S = x (P-V) + y (V-P)$ is affected by the hedging of economic risk in A, in that the HF will get from the derivative contract entered into, an amount equal to y (P-V)
Provided this theoretical framework, reality has demonstrated that the HF s have been active—sometimes with recourse to “empty voting”, often without—in blocking acquisitions on the acquirer side (see the Deutsche Borse-LSE failed merger) or blocking acquisitions on the target side (see Novartis-Chiron and Sears Canada); or, again, in facilitating acquisitions on the target side via activism on the acquirer side. This latest setting corresponds to our last scenario, in which the HF plays on the offensive side and matches a conflicted shareholder position with empty voting, and raises the highest concerns due to the distortion of the incentives created.

The numerical analysis has demonstrated that this coupling feature has important consequences under two aspects. On the one hand, the HF has peculiar economic incentives in that it is economically indifferent as shareholder of the acquirer, but eager to an overpayment as shareholder of the target. On the other hand, the HF enjoys a crucial advantage under the “ownership” profile, because it can take a substantially strong position also in the acquirer, even larger than in the target (whereas in standard transactions only the opposite is economically justified). Therefore, it is more likely that the HF would have an “influential” or even “dominating” grasp on the deal. Moreover, the HF will likely bear no share of that overpayment due to its hedged position, while the fellow (disinterested) shareholders will bear it all, contrary to what generally happens in “traditional” overpayment circumstances.

The main issue here is not just fairness. A strong economic rationale calls for the involvement of the disinterested fellow shareholders in the approval of the merger. As shown, in the worst scenario, when HF takes a conflicted shareholder position by holding shares of both the acquiring and the target companies and it totally lays off the economic risk related to the acquirer company, it internalizes all the benefits and externalizes all the costs of the acquisition. In this situation, the fellow (disinterested) shareholders who do not engage in empty voting are the very residual claimants of the company.

In addition, from a welfare perspective, the interest of the HF in an overpayment is economically justified from an individual point of view, but not necessarily (socially) efficient. Merger transactions imply an assessment of the marginal costs incurred to accomplish the transaction, which consist in the premium paid to acquire the target company (i.e., the spread between price P and value V), and the marginal benefits yielded by the merger, such as those deriving (or, - y (V-P)), so that the second part of the formula is equal to zero, regardless of the price (P) paid.

See Thompson supra note 1, at 14-15 (providing these examples for activity related to existing acquisition transactions). See also Kahan & Rock, supra note 1, at 1034-1042 (categorizing the same activity in (i) blocking acquirers; (ii) blocking targets; and (iii) making bids).

For anecdotal evidence of these patterns, other than the King-Mylan case, see Hu & Black, Empty Voting II, supra note 2, at 634 (describing the M-Flex/MFS case: “... Stark, a hedge fund, held at least 48% of the minority M-Flex shares and had an incentive to vote for the offer even if it was bad for M-Flex. Stark owned a large stake in the target, MFS, and had hedged most or all of its interest in M-Flex. It would therefore be happy if M-Flex overpaid for MFS”).

See Martin & Partnoy, supra note 1, at 776 (citing the agency costs rationale to the one-share-one-vote principle, according to which the shareholders have voting powers as “the group with appropriate incentives to make discretionary decisions because they receive most of the marginal gains and incur most of the marginal costs of those decisions”) (citations omitted).
from economies of scale and scope or other synergies. Efficiency requires that marginal costs equal marginal benefits.

The empty voting tactic, instead— if employed under the mentioned circumstances— seems to exacerbate the traditional overpayment problem in corporate acquisitions. The HF would systematically overpay for the target, likely making the marginal costs higher than the marginal benefits, forcing the deal through by virtue of its strong and possibly dominating position. If HF does not have the right incentives and it is not in the right position to assess the costs (and the benefits) of the merger, the fellow shareholders are in the right position to say whether they are willing to pay a certain premium to have an (allegedly) more efficient company. This calls for a policy intervention based on the involvement of the disinterested fellow shareholders in transactions where empty voting is used, as discussed in detail in Part IV infra. This is all most true to the extent that the HF might have some influence on the management of the acquirer, as suggested by empirical studies reported in the following Section III.B.

B. Empirical Evidence on Hedge Funds’ Activism

Before formulating any policy proposal, it is also necessary to report the current empirical studies on HF activism, with particular attention to the findings on the m&a area. These recent works have accurately analyzed the impact of HF activism, basically suggesting that HFs have an overall beneficial effect on companies they target. However, it is also worth noting that they seem to have overlooked the problematic issue of the empty voting tactic.

April Klein and Emanuel Zur have empirically investigated the causes and consequences of HF activism as compared to traditional institutional investor activity. The authors define HF activism “as a strategy in which a HF purchases a 5 percent or greater stake in a publicly-traded firm with the stated intent of influencing the firm’s policies” and rely on SEC Schedule 13D filings to study the phenomenon. The authors identify 194 13D filings by HFs between 2003 and 2005, which are narrowed to 155 if only first filings are traced backwards. As for the m&a arena, the authors have found 18 filings related to “opposing a merger,” 16 events related to “supporting a merger” (as in the King-Mylan case), and 12 events related to the possibility of a takeover of the firm by the HF. The m&a area seems therefore an important field of the HF activism as these transactions— directly related to mergers or acquisitions – account for 29% of the overall HF activity (46 out of 155). The success rate of HF demands is also reported and it turns to be rather significant as evidence shows that HFs succeed in their goals in slightly more than 50% of the time. These findings show a strong presence of

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39 Klein and Zur, supra note 12. This is an example of the signalling function performed by the HFs, as mentioned supra in Part II.
40 Id. at 15.
41 Id. at 29 and table VI (reporting a 56% success rate as to “opposing a merger” (10 out of 18), 56% as to “supporting a merger” (9 out of 16), 58% as to “takeover intent” (7 out of 12). The
HF in m&a operations, but do not report any empirical evidence on the employment of empty voting, a fact that confirms the lack of disclosure in the area.

With regards to the effect of the HF investment on the target companies, the work shows that “over a period of 61 days, surrounding and including the filing date, firms targeted by HF activists have an abnormal return of 10.3%”, whereas non-HF targeted firms have a return of 5.2%. However, there is evidence suggesting that HFs do not improve the accounting profitability of the targeted firms (and earnings even drop in the year following the investment). In addition, empirical data show a strong impact on cash and debt load, and on the firms’ dividends policy. Indeed the report shows, after the HF 13D filing, a significant reduction in the excess cash on hand, an 11.6-cent increase in dividends per share, and a significant rise in both the total debt and long-term debt load.

The authors read these results as consistent with Jensen’s “free cash flow” theory, suggesting that the HF activism can enhance the shareholders’ value by increasing the firm’s debt load and thus reducing agency costs related to excessive cash flow and short-term investments. Finally, the work reports that the market reacts positively to the information of the HF investment (13D filing), and, on these grounds, the authors infer that “the market perceives the HF’s intervention as a value-increasing event”.

Another empirical work shows similar findings. The authors report that HF activist target companies that are typically “value” but not large-cap firms, in which payout before intervention is lower than that of a matched sample. The paper finds that the market reacts favorably to activism, consistent with the view that it creates value, and with evidence of overall improved performance at target firms. Empirical data suggest that HFs are able to create value out of large allocative inefficiencies. Finally, the paper stresses the important “hybrid” governance role of HF activists, which “occupy an important middle ground between internal monitoring by large shareholders and external monitoring by corporate riders. … This hybrid internal-external role puts activist HFs in a potentially unique position to reduce agency costs associated with the separation of ownership and control”.

William Bratton has also gathered interesting data on the impact of HF intervention on 114 target companies. The study confirms that HFs preferably target cash-rich, smaller companies; that HFs are not short-term investors extracting cash and exiting immediately (with 63% of the investments in the

42 Id. at 36.
43 Id. at 42 (referring to a theory of Harvard Business School’s Prof. Michael C. Jensen).
44 Id. at 30 (confirming another possible application of the signalling function performed by the HF activity).
45 Brav, Jiang, Thomas & Partnoy, supra note 17 at 2.
46 Id. at 3.
47 Id.
48 Id. at 5.
sample lasting more than one year).\textsuperscript{49} HFs are extremely successful in obtaining their instances (82% success rate in hostile transactions).\textsuperscript{50} As to the impact on the governance and performance of target companies, the data do not offer strong evidence of impact on cost cutting but do show, consistently with the previous study, a strong impact on payout policy (either by dividends payments or by stock repurchases), accomplished either by cash flow disgorgement or by debt loading. These allegedly beneficial effects advocate in favor of HF intervention.\textsuperscript{51} Furthermore, the study investigates value creation by HFs in terms of portfolio returns. Here, the results are mixed and do not clearly support the claim that HFs beat the market.

Finally, and more interestingly for the purposes of this research, the work analyzes the impact of the HF activism on the market for corporate control – \textit{i.e.}, in the m&a arena. The sample of 25 transactions in which at least one HF has been active, shows that the activists do influence the results of the operations, either terminating the acquisition attempt or obtaining a price increase (depending on the position of the HF), as only in five cases the transactions’ terms were not altered by the HF move. The author concludes that HF pressure on company’s management can discipline the managers to be more careful in selecting and pricing their acquisitions, both on the acquiring side, where overpayments will be reduced, and on the target side, where a higher premium will be claimed.\textsuperscript{52} The results of these studies are consistent with the cost-benefit analysis developed above in Part II and suggest that, in general terms, HF activism is a “more benign phenomenon” than some critics would depict. However, the studies overlook the empty voting problem, even though this tactic is being increasingly employed, in particular in the m&a area, and in many transactions it could have passed silently due to lack of disclosure. If empty voting is taken into account, then some results seem to be challenged under theoretical assumptions and probably need reconsideration, at least with regard to some specific transactional postures (such as those typical of the King-Mylan case) in which the HFs have an overall negative economic ownership.

As mentioned before, when the HF holds more shares in the acquirer than in the target and hedges the economic risk associated with the acquirer position, the overpayment problem is exacerbated by empty voting. Professor Bratton himself recognizes the traditional overpayment issue, even in transactions without recourse to empty voting;\textsuperscript{53} the author dismisses the claim, arguing that corporate law is less concerned about the acquirer side, where, at best, the acquirer shareholders have a vote; in addition, shareholders are, again, less concerned about high premiums because they are probably diversified and maybe

\textsuperscript{49} Bratton, \textit{supra} note 12, at 1413 (reporting only three cases of opportunism: King-Mylan, Temple-Inland and Gyrodyne. Carl Icahn was active in first two cases. Only the last one was, however, a case of abuse, in the form of greenmail).
\textsuperscript{50} \textit{Id.} at 1403.
\textsuperscript{51} \textit{Id.} at 1418 (noting that “hedge fund activism has not been replaying the 1980s leveraged restructuring”, even though “the activists responsible for three of the eight levered capital structures, Carl Icahn . . . and Nelson Peltz . . . are 1980s’ veterans.”).
\textsuperscript{52} \textit{Id.} at 1427.
\textsuperscript{53} \textit{Id.} at 1424-25 (recalling that merger premium in most cases are so substantial to “arrogate the entire merger gain to the selling shareholders” and reporting empirical studies showing consistent losses to buy-side shareholders and negative combined results in mergers between 1998 and 2001).
also on the other side of the transaction. These arguments seem, however, to be challenged in literature.

However, a recent empirical study has highlighted the “dark side” of merger arbitrage, in line with the main point of this paper. The paper stresses the incentives distortion suffered by the HFs in mergers in which they stand on both sides of the transaction – a distortion that can be exacerbated by empty voting. On the offensive side, the HFs might have an incentive to favor even value-destroying (inefficient) mergers, whereas on the defensive side, HFs might engage in anti-merger strategies, taking positions that would benefit if a merger collapsed, and then strategically voting against the merger. The authors provide anecdotal evidence, including the King-Mylan case, suggesting that (i) HF voting has led to suboptimal approval of mergers, and (ii) several merger votes have been so close that hedge voting may have determined the outcome. The authors therefore conclude that HFs’ role in merger arbitrage might be problematic.

The following Section shows how empty voting, matched with a conflicted position, by the HF can lead to approval of inefficient mergers.

C. Developing the Stage: Incentives to Approve Inefficient Transactions

In this Section, it will be shown that, from a theoretical perspective, the recourse to empty voting in mergers in which the HF is on both sides of the operation requires legal response because it makes more likely value-destroying (inefficient) mergers.

For these purposes, the formula (1) developed in Section III.A supra needs to be perfected. According to the formula (1), absent any efficiency aspects, the HF payoff or economic interest \( S \) yielded by the merger is given by the formula:

\[
S = x (P-V) + y (V-P) \quad (1)
\]

This formula, however, does not take into account the efficiency implications of a merger, such as economies of scope or scale or other synergies. When efficiency is taken into account, the HF payoff or economic interest \( S \), upon accomplishment of the merger, is given by the formula:

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54 Id. at 1426.
55 See Kamar, supra note 38, at 5-6 (citing a study advancing that target shareholders are well protected, whereas acquirer shareholders are far less protected as “[c]ourts rarely scrutinize acquisition decisions, most acquisitions do not require shareholder approval, and federal law protects acquirer shareholders only when they vote”).
56 Partnoy & Thomas, supra note 5, at 39-42.
57 Id. at 39 ( “[A] hedge fund that owns target shares and is short acquirer shares has an incentive to vote in favor of the merger, even if the merger will result in a reduction in the aggregate value of the acquirer and target”).
58 Id. at 41 (reporting the King-Mylan case and stating that “[t]o the extent shareholders have hedged the economic risk of their shares positions, they likely would vote in ways that are contrary to the interests of shareholders who do not hold any countervailing positions”).
59 Id. at 40.
\[ S = x(P-V_1) + y(V-P) \]  
\[ S = xV_1 + yV_2 \]

and the HF payoff or economic interest \((S)\) if no merger occurs is given by the formula:

\[ S = xV_1 + yV_2 \]

where \(V_1\) is the pre-merger value of the target (T); \(V_2\) is the pre-merger value of the acquirer (A); and \(V\) is the post-merger value of the merged company. From an efficiency perspective, a merger is value-creating if \(V > V_1 + V_2\) (efficient); a merger yields no synergies if \(V = V_1 + V_2\) (neither efficient nor inefficient); and a merger is value-destroying if \(V < V_1 + V_2\) (inefficient).

Therefore, the HF gain \((G)\) from the accomplishment of the merger is given by the formula:

\[ G = [x(P-V_1) + y(V-P)] - [xV_1 + yV_2] \]

Now suppose that the HF holds 20% of the acquirer stock and 10% of the target stock; that the value of the target is $3 \((V_1 = $3)\), the value of the acquirer is $10 \((V_2 = $10)\) and the merger is inefficient as the value of the merged company would be $11 \((V = 11)\). Suppose further that the price for the acquisition is $15 (overpayment).

Without empty voting, the HF gain would be equal to

\[ G = [0.1($15-$3) + 0.2($11-$15)] - [0.1x$3 + 0.2x$10] = -$1.9 \]

The HF will not want to approve and pursue the inefficient merger as its gain would be negative \((i.e. -$1.9)\).

Suppose now that the HF enters into a derivative which off-set the amount \(y\) \((V-P)\), keeping 20% of the voting rights in the acquirer but no economic interest. As shown before, this allows the HF to take a substantial stake in the acquirer (even larger than in the target), with the possibility to influence the price of the acquisition and having an incentive to push for a high overpayment. Suppose the price for the acquisition is now set at $27.

In fact, with empty voting, the HF gain would be equal to

\[ G = [0.1($27-$3) + 0.2($11-$27)] - [0.1x$3 + 0.2x$10] + [0.2($27-$11)] = $0.1 \]

Under this scenario, the HF will have a positive gain \((i.e. $0.1)\) and therefore will approve and pursue the merger even if inefficient. On these grounds, and on the ground that the empty voting tactic impacts the voting procedure in the corporate machinery also under a purely legal perspective, a case for policy intervention has been advanced.

IV. FRAMING FIDUCIARY DUTIES AND STANDARDS OF REVIEW IN MERGER AND ACQUISITION TRANSACTIONS INVOLVING EMPTY VOTING
A. The Existing Policy Proposals

Empty voting has already created a lively debate in the literature. From a policy perspective, some scholars have already formulated their proposals. They have addressed so far either disclosure profiles or corporate law.

Henry Hu and Bernard Black have initially advanced a structured proposal to uniform the disclosure requirements related to the different forms that the employment of financial engineering contracts might take. The disclosure profile is certainly crucial also for a policy proposal focused on corporate law fiduciary duties. An effective system of disclosure is a pre-requisite for the application of any judicial scrutiny on these transactions and is therefore to be backed. As discussed below, in a lawsuit the burden to prove the existence of empty voting would be likely not met without some reform of empty voting disclosure requirements.

Shaun Martin and Frank Partnoy have instead stressed substantive aspects of the empty voting tactic under a corporate law voting rights profile. According to their proposal, interested shareholders (HF) should not be entitled to vote on the merger approval or any other shareholder’s meeting decisions where they have direct financial conflicted interests. This proposal basically mandates an abstention obligation in order to re-establish the economic rationale underpinning the one-share-one-vote principle. Under this approach, empty voting would be certainly sterilized and the voting powers aligned with the economic ownership. The possible downside here consists in the fact that it might be difficult to detect exactly the moment when HF engages in empty voting. Aware of these potential problems, they have thus made their proposal dependent on the costs incurred in the efforts to detect the employment of the financial engineering contract leading to “encumbered shares”.

Robert Thompson and Paul Edelman have also advanced a policy proposal on empty voting which goes beyond disclosure enhancement. They

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60 Hu & Black, The New Vote Buying, supra note 1.
61 Id. at 819 (predicting that timely disclosures will let the Delaware courts address empty voting issues on a case-by-case basis under corporate law principles). See also Anish Monga, Using Derivatives to Manipulate the Market for Corporate Control, 12 STAN. J.L. BUS. & FIN. 186 (2006) (applying current law regarding vote-buying to empty voting and concluding with a policy suggestion based on disclosure enhancement).
62 See also Kahan & Rock, supra note 1, at 1077 (agreeing with Hu & Black’s initial take that “not enough is known about the extent of empty voting to prescribe anything more than an increase in disclosure of schemes generating empty votes”).
63 Martin & Partnoy, supra note 1, at 793 (arguing that “corporate voting should be structured so that pure residual claimants have the general ability to control the corporation’s decisions, since they gain or lose at the margin. The corollary to this argument is that those shareholders with encumbered positions should not be entitled to vote, since such shareholders would favor proposals that would not maximize the value of the corporation”).
64 Id. at 793-794 (making their abstention obligation proposal depending on the costs involved in the detection task).
65 Thompson & Edelman, supra note 1, at 25-26 (“Disclosure, however, will not necessarily prevent the counterparty from agreeing to an empty voting transaction. . . . Further, to the extent that traders like Goldman Sachs and Morgan Stanley are not using their own money, there is an agency problem in which the costs of the swap will not become visible to the principal or the voting value can be buried within a larger trading strategy”).
push for “a modern adaptation of the traditional corporate law ban on agreements that separate voting from control and on vote buying”, in particular proposing (i) to require one-share-one-vote, (ii) a ban on agreements that de-couple voting from economic ownership, and (iii) a ban on vote buying.\textsuperscript{66}

Henry Hu and Bernard Black have recently elaborated on a policy proposal beyond disclosure enhancement which is based also on corporate law.\textsuperscript{67} Their policy proposal is rather articulated and impacts three areas: (i) voting rights, (ii) supply and demand of empty voting, and (iii) mechanics of shareholder voting.\textsuperscript{68} For our purposes, Hu and Black propose, among other things, providing companies power to amend their charters to limit empty voting. In extreme cases they also propose an abstention obligation by barring the shareholders with a negative economic ownership to vote.\textsuperscript{69}

In case of corporate charter litimation, the direct limit on the voting rights would be implemented through a shareholders’ attestation, \textit{i.e.} a statement in which large shareholders (meaning shareholders holding more than 1% of the share capital) would attest their economic ownership when they vote. Should the attestation report a relevant mismatch between economic and voting ownership pursuant to the corporate charter, the relevant shares would be disallowed. Disallowed shares will not be counted for among outstanding shares for quorum purposes.\textsuperscript{70} The authors admit that detecting nonvotable shares and therefore shares that should be disallowed might be technically difficult.\textsuperscript{71} In case of negative economic ownership, the authors propose that state corporate law should assume that shareholders with negative economic ownership would vote against the interests of other shareholders and thus disallow their voting rights.\textsuperscript{72} In both cases of corporate charter limitation and negative economic ownership, under this policy proposal, the HF (or any other player) engaging in empty voting would not be allowed to exercise its voting rights. The authors claim that such rule is similar to rules requiring MOM approval for freezeouts and related party transactions. In Section IV.D \textit{infra}, I show the difference between the two.

Finally, Iman Anabtawi and Lynn Stout have a paper investigating the fiduciary duties of shareholders as opposed to directors. Corporate law traditionally assigns fiduciary duties to directors and officers and, in some limited cases, such as the presence of controlling shareholders or close corporations, to shareholders. The authors argue that fiduciary duties in general, and the duty of loyalty in particular, should be applied to activist non-controlling shareholders as well (read: activist HFs), should (i) the activist shareholder be able to influence the outcome of a particular corporate decision in which (ii) it has a material, personal pecuniary interest.\textsuperscript{73} The authors acknowledge that shareholders’ conflicts of interest may arise in situations other than freezeout or close

\textsuperscript{66} Id. at 27.

\textsuperscript{67} Hu & Black, \textit{Empty Voting II}, supra note 2, at 694, 3 IV.

\textsuperscript{68} Id. at 694-721.

\textsuperscript{69} Id. at 701.

\textsuperscript{70} Id.

\textsuperscript{71} Id.

\textsuperscript{72} Id. at 702.

\textsuperscript{73} Anabtawi & Stout, \textit{supra} note 1, at 50-51.
corporation cases\textsuperscript{74} and include empty voting among those conflicts triggering fiduciary duties.\textsuperscript{75} Although the approach followed by these authors is similar to the approach of this paper, which is grounded in the application of the existing fiduciary duties doctrine to the emerging empty voting phenomenon, as opposed to \textit{ad hoc} policy responses, some specific difference still remain between the two policy proposals. The following Sections give account also of these differences.

B. Framing the Issue: Empty Voting in Merger and Acquisition Transactions and the “Disinterested Shareholders’ Approach”

In the following Sections, I will develop a functional fiduciary duties approach to the problematic issue of the empty voting device in m&a transactions. This approach infers an adjustment to the current Delaware corporate law standards of review, as already proposed by the same creators of the Delaware corporate law standards of review and legal scholars.\textsuperscript{76} Under this “disinterested shareholders’ approach”, every transaction involving empty voting should be approved by a majority of non-empty voter disinterested shareholders (MOM requirement) – the actual residual claimants in transactions involving empty voting. As to the application of the standards of review to these transactions, approval by the majority of disinterested shareholders triggers the business judgment presumption in order to provide incentives to the directors to obtain such approval. The proposed approach also distinguishes between HF “controlling” shareholders (as defined in Section IV.D \textit{infra}) and HF “swing vote” shareholders.\textsuperscript{77} In the former situation, without the MOM approval, the transaction would be scrutinized under the entire fairness standard (as discussed in detail in Section IV.D \textit{infra}), whereas in the latter situation, without MOM approval, the transaction would be scrutinized under the business judgment standard with a shift in the burden on proof on the defendant directors (as discussed in detail in Section IV.E \textit{infra}).

As mentioned in the Introduction, the King-Mylan merger is unanimously recognized as the most critical empty voting case occurred so far in the business arena by the leading legal scholarship.\textsuperscript{78} The transactional features of

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{74} \textit{Id.} at 51 (indicating “conflicts over merger strategies, special dividend declarations, and stock repurchases”).
\item \textsuperscript{75} \textit{Id.} at 36-47 (including conflicts arising from (i) activists’ transactions with the corporation, (ii) activists’ interests in derivatives or securities of other corporations, (iii) activists’ investments in other parts of the corporation’s capital structure, and (iv) activists’ short investment horizons).
\item \textsuperscript{76} See William T. Allen, Jack B. Jacobs and Leo E. Strine, Jr., \textit{Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law}, 56 BUS. LAW. 1287, 1317 (2001) (arguing that either MOM approval or ISC approval should trigger the business judgment rule); see also Guhan Subramanian, \textit{Fixing Freezeouts}, 115 YALE L.J. 2, 61 (2005) (arguing that only the combined action of MOM approval and ISC approval should trigger the business judgment rule).
\item \textsuperscript{77} Anabtawi & Stout, \textit{supra} note 1, at 21, 52-53 (including instead the “swing vote” shareholder position in their notion of “controlling shareholders”).
\item \textsuperscript{78} See Kahan & Rock, \textit{supra} note 1, at 1075 (describing the transaction as a “particularly extreme form of a hedging-related conflict”); Thompson, \textit{supra} note 1, at 16 (describing the “controversial” takeover as the “most questionable context of hedge fund activism [that] has provoked an extensive debate around empty voting”); Hu & Black, \textit{The New Vote Buying}, \textit{supra}
\end{enumerate}
\end{footnotesize}
that operation are the following: (i) the transaction is structured as a merger and not as a tender offer; (ii) the consideration involved is a stock-for-stock exchange; (iii) the HF owns a 9.9% blockholding of the acquirer (being the largest shareholder of the company); (iv) the HF is standing on both sides of the transaction, holding also shares of the target company; and (v) the HF employs financial engineering contracts with reference to its shares in the acquirer, totally hedging his financial risk but keeping its voting rights (recourse to empty voting on the acquirer side).

From an economic interests’ perspective, the King-Mylan type of transaction shows a strong incentive for the HF to push for an overpayment and therefore, on the one hand, seems to share some features of conflicted mergers, where shareholders are on both sides of the transaction; and, on the other hand, some features of traditional freezeout mergers, where a controlling or dominating shareholder is forcing the deal in order to cash the minority out. Traditionally, under those circumstances, the disinterested fellow (minority) shareholders need protection. Empty voting will be investigated as a legal technique that exacerbate this need for protection.

The scope of the disinterested shareholders’ approach is broader than the transactional pattern of the King-Mylan case. Approval by a majority of disinterested shareholders might be required for every transaction in which accomplishment might be influenced by empty voter shareholders. However, in the following Sections, the analysis will be focused on m&a transactions, with particular reference to mergers, provided that at least anedoctal evidence seems to suggest that in the merger arena the HFs are particularly active and conflicts of interest are likely to arise, as HFs may stand on both sides of the transaction.79 This leaves room for research into the expansion of the disinterested shareholders’ approach to tender offers, and transactions outside the m&a context.

C. Duty of Loyalty Cases and the Applicable Standard of Review

First, I will survey Delaware current case law governing merger transactions where structural conflicts of interest are present and a duty of loyalty is invoked to impose fiduciary duties on the management and/or on the controlling shareholders.80

The freezeout mergers are the typical transaction where conflicts of interest and related duty of loyalty-backed fiduciary duties arise. In a classic operation, the de jure controlling shareholder buy out the minority fellow shareholders, with or without their consent. The risk of underpayment is evident here.

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79 Partnoy & Thomas, supra note 5, at 42 (“Overall, we believe that the role of hedge funds in merger arbitrage is problematic”).
80 See also the case law analysis by Anabtawi & Stout, supra note 1, at 19-24.
Weinberger v. UOP, Inc., applies to freezeout mergers involving a controlling shareholder. In Weinberger, Signal Co. held 50.5% of outstanding shares of UOP, Inc. and decided to buy out the minority shareholders’ interests at $21, when UOP’s shares were trading at $14. The Signal management delegated the performance of a feasibility study of the acquisition to two Signal officers, who happened to be also members of the UOP board of directors. The insiders’ memo concluded that “it would be a good investment for Signal to acquire the remaining 49.5% of UOP shares at any price up to $24 each”. Lehman Brothers was retained to render a fairness opinion as to the price offered to the minority shareholders. In short notice, the investment bank performed the due diligence and issued a first draft of the fairness opinion in which allegedly the price assessed by Lehman Brother had been left blank. After reading the draft opinion, while en route to the UOP directors meeting, a Signal officer inserted a price of $21 per share into the final form of the fairness opinion. Signal’s board unanimously authorized the cash merger proposal of $21 per share, making it conditional upon the approval by a majority of UOP’s outstanding minority shares voting at the relevant shareholders’ meeting and (when combined with Signal’s 50.5% interest) upon the approval by at least two-thirds of all UOP shares. The insiders’ memo was disclosed to neither the UOP directors nor shareholders and became the turning point of the court judgment.

It should be emphasized that in Weinberger, the transaction was critical because some Signal directors were also on the board of directors of UOP and who did not engage in any resistance to the majority proposal. However, more critical than any domination of the UOP board by the majority shareholders, the disclosure profile is the main teaching of Weinberger: even an approval by the majority of minority shareholders (MOM approval), which intervened, was not deemed sufficient by the court to heal the informational deficiency. The Supreme Court therefore reversed the judgment of the Court of Chancery, which had found the transaction to be fair.

As to the standard of review, Weinberger poses the entire fairness standard to conflicted mergers under the cited circumstances. The court in particular held that in case of “an interested merger, . . . the controlling or dominating shareholder standing on both sides of a transaction . . . proponent of the transaction bears the burden of proving its entire fairness”. However, even if not a legal prerequisite, the approval of the transaction by an informed vote of a majority of minority shareholders shifts the burden of proof to the plaintiffs who must show that unfairness of the merger.

82 Id. at 705.
83 Id. at 712 (“The minority stockholders were denied the critical information that Signal considered a price of $24 to be a good investment. . . . [W]e cannot conclude that the shareholder vote was an informed one. Under the circumstances, an approval by a majority of the minority was meaningless”).
84 Id. at 703 (specifying also that “even though the ultimate burden of proof is on the majority shareholder to show by a preponderance of the evidence that the transaction is fair, it is first the burden of the plaintiff attacking the merger to demonstrate some basis for invoking the fairness obligation”).
85 Id.
The court was also generous to the cause of transactional lawyers. The opinion is a helpful guide laying out transactional details to meet the entire fairness standard. The court highlighted the importance of several factors affecting the dealing process, from timing to negotiation to disclosure, and most importantly, it gave a first but clear indication on the use and the effect of a companion cleansing device, other than the MOM approval: the independent special committee (ISC). In a note, the court suggested that the appointment of an independent special committee charged with the task of negotiating with the majority shareholders would have recreated the conditions for an arm’s length deal, and likely met the entire fairness standard.86

After Weinberger and during the takeover wave of the 80s, sustained by the high availability of junk bond loads, the use of the two cleansing devices became common (but not always best) practice. In 1985, just two years after Weinberger, Rosenblatt v. Getty Oil tested the new MOM conditions in the stock-for-stock merger between Skelly and Mission Corporation into Getty Oil Company.87 Getty owned either directly or through Mission nearly 80% of Skelly and, after the death of its founder J. Paul Getty – historically against such a merger – the management informed the Skelly peers that a combination of the companies was being considered. The record reports lengthy negotiations with the appointment of investment banks and specialist engineering firm engaged in difficult valuation proceedings. The exchange ratio, fiercely negotiated by both parties and finally struck at 0.5875, along with the other merger terms was approved unanimously by the boards of directors and submitted to the Skelly’s shareholders. 89.4% of the minority shareholders approved it. After consummation of the combination, a class action was filed against Getty claiming that, among other things, the exchange ratio was unfair. The court affirmed the Court of Chancery judgment, entering for the defendants.

Two important features seem to have been significant in the negotiation. In the first instance, the arm’s length nature of the negotiations was warranted by the economically opposed objectives pursued by the two parties, which more than once led to the verge of complete collapse of the negotiation process; and, secondly, both parties set up a primitive but conclusively effective pre-Weinberger “independent bargaining structure”, contrary to what happened in Weinberger.88 As to the standard of review, the court recognized the “potential conflicts among the interlocking managements of the two companies” (but found no evidence showing that the majority shareholders set the terms of the merger) and did not pass to a business judgment presumption, confirming the entire fairness test, even with MOM approval. Rosenblatt is a happy story of how prima

86 Id. at 709 n. 7 (“the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm’s length. . . . Particularly in a parent-subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm’s length is strong evidence that the transaction meets the test of fairness”).
88 Id. at 938 (“the divergence in objectives insured the arm’s length quality of the bargaining between the Getty and Skelly teams on asset value”); Id. at 938 n. 7 (“Hara, Skelly’s president, formed a team to negotiate merger for Skelly . . . . Similarly, Getty selected Kenneth Hill . . . . to be its chief negotiator; Hill resigned his Skelly directorship on July 15, 1976. This independent bargaining structure, while not conclusive, is strong evidence of the fairness of the merger ratio”).
facie conflicted positions and fair dealing and price may coexist and suggests that the underpinning economic interests objectives and the parties response to possible distortions should drive the research for the correct and efficient standards of review.

From a transactional perspective, however, from the 80s onward the two cleansing devices (MOM approval and ISC approval) have been increasingly used and the courts have initially developed two different approaches. On the one hand, under a more deferential sensitivity, the business judgment rule would be triggered by the approval of the merger by an independent special committee, on the other hand, regarding Rosenblatt, neither the ISC nor the MOM approval would trigger the business judgment rule, but they would shift the burden of proof to the plaintiff to show the unfairness of the transaction.

In Kahn v. Lynch Communications Systems, the Delaware Supreme Court, resolving that conflict of authority, held that both processes would have the same cleansing force and confirmed that, even after such cleaning devices are employed together, entire fairness would remain the standard of review, but a shift in the burden of proof would apply. From a structural perspective, Lynch represents a freezeout merger with the presence of a de facto controlling shareholder. Here, Alcatel, holding 43.3% of the outstanding stock of Lynch, was a (non de jure but) de facto controlling shareholder and, after some opposition to Lynch’s business decisions, proposed to buy out the minority for $14 per share in cash. Lynch’s board set up an independent committee to negotiate the terms of the merger with Alcatel. After some negotiations, Alcatel made its final offer of $15.50 cash per share and added that if the offer would not be recommended by the ISC and approved by the board, it was “ready to proceed with an unfriendly tender at a lower price”. Faced with no alternatives and the threat of a worse treatment, the ISC recommended the merger and the board approved.

A class action was brought by Lynch minority shareholders against Alcatel challenging the fairness of the merger. The Court of Chancery found that Alcatel was a controlling shareholder who owned fiduciary duties to Lynch and its fellow shareholders but found no breach of duties and entered judgment in its favor. The Supreme Court, however, reversed and remanded for further proceedings with the burden of proof remaining on Alcatel. The court noted that, notwithstanding the restricted choice, the ISC can not abdicate its duty to pursue a fair price, just because the price offered is the best price available, and has therefore a “power to say no”. In the case, this (bargaining) power had not been exercised because Alcatel not only threatened the ISC and the board with a hostile tender offer, but also dominated the business of Lynch for its own interest. In other words, the court found that Alcatel dictated the terms of the transaction, had a substantial influence on the board and, through a hostile tender offer threat, compromised the ISC’s ability to negotiate at arm’s length.

92 Id. at 1113 (Del. 1994).
93 Id. at 1117 (Del. 1994).
The cited opinions have scrutinized only freezeout or going private transactions where a controlling shareholder is willing to buy out the minority. Even if these operations are structurally different from the King-Mylan merger, they share some common features from an economic interests’ perspective. In both circumstances, the “disinterested” shareholders bear the risk of not obtaining or paying the fair price. The shareholders of the target company may be forced to accept an underpayment, whereas the shareholders of the acquiring company may be forced to disburse an overpayment.

Not only do loyalty fiduciary duties arise in freezeout mergers due to possible conflicts of interest, but they may also arise in the context of the sale of the corporation to a third party by the controlling shareholders. In sale context, the controlling shareholders might decide just to sell the majority stake in a private transaction with the third party, or instead might go for the sale of the entire corporation. Recently, with particular reference to this kind of transaction, *McMullin* has scrutinized a “merger of a subsidiary with a third party [where] the controlling shareholder wants the merger to occur and the minority shareholders are powerless to prevent it”.*94* In this case, the minority shareholders brought an action against the 80% controlling shareholders claiming that the transaction was at the behest of the controlling shareholders as they were involved in the negotiations of the terms and timing of the deal. The plaintiffs alleged that the board of directors was controlled (8 out of 12 directors were not independent because of their prior affiliations with the controlling shareholders) and the negotiations of the merger were improperly delegated to the controlling shareholder who pursued its own interests, namely a need for cash. The Supreme Court, reversing the Chancery judgment and remanding, held that “in such situations, the directors are obliged to make an informed and deliberate judgment, in good faith, about whether the sale to a third party that is being proposed by the majority shareholder will result in a maximization of value for the minority shareholders” (emphasis added). The opinion stresses the crucial role of the board of directors, which cannot abdicate its duty to maximize the value for all shareholders.

From a structural perspective, *McMullin* involves a sale of the corporation to a third party (and not to an insider), and therefore the transactional setting is closer to the King-Mylan merger, even if the presence of a controlling shareholder as opposed to a 9.9% shareholder remains a marked difference. However, the court’s concern over the maximization of value for the minority shareholders (in this case, of the target company because of the underpayment risk) is a clear policy indication of the economic rationale which might be applied also to conflicted mergers involving empty voting.

In addition, *Omnicare* touches upon the relationship between the directors and the majority shareholders which might be critical also in transactions where HFs and empty voting are involved.*95* In *Omnicare*, Omnicare brought an action challenging the merger between NCS and Genesis for breach of fiduciary duties. The deal involved a voting agreement between Genesis and two insiders and major NCS shareholders (holding together more than 65% of the voting rights in NCS), according to which the two insiders agreed to vote in favor of the

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95 *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).
merger. So, when the terms of the merger between NCS and Genesis were overcome by a cash tender offer launched by Omnicare at better terms, the NCS board did not dare to recommend the merger to the shareholders and withdrew its recommendation, claiming that this move would meet the fiduciary duties owned to the stockholders. However, in a 3-2 decision the court found that the decision of the board to act in concert with the controlling shareholder to lock up a merger created in this case *a fait accompli*, due to the majority stake of the two insiders; and the withdrawal of the recommendation to approve the merger was not a sufficient discharge of the fiduciary obligation.

The minority opinion, however, described the central issue as to whether the board has taken actions that “have the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction”. The record did not support such a finding, because, at the time of the voting agreement, the Genesis proposal was the “only party in town”, and on these grounds, the minority opinion held that a lock-up device is not illegal per se, and when there is no evidence of self-interest and lack of care, the proper standard is the deferential business judgment rule.

Omnicare is predicted to be unstable law because of the unusual split within the Delaware Supreme Court, but it is an interesting case in that it stresses the close relationship between some shareholders and the management. For our purposes, as far as King-Mylan-type mergers are concerned, Omnicare may suggest to distinguish between transactions where the HF exercises any influence on the management (or conversely, the management causes the HF to vote in favor of the proposed transaction for some reason other than the merits of that transaction) and transactions where such issues do not arise.

Finally, in *In re Wheelabrator*, Waste Management, Inc. acquired Wheelabrator Technologies, Inc. where it was also the largest shareholder holding 22% of the share capital and having nominated four of the eleven directors of WTI. After the unanimous approval of the merger by the WTI board of directors, the majority of disinterested shareholders (WTI’s shareholders other than Waste) also approved the transaction after the terms were improved during negotiations. A class action was brought by some of WTI’s shareholders against Waste and the company’s directors to challenge the merger for breach of fiduciary duties, including the duty of loyalty. The plaintiff claimed that “a majority of WTI’s eleven directors had a conflict of interest that caused them not to seek or obtain the best possible value for the company’s shareholders in the merger”. The court held that a fully informed vote by the majority of disinterested shareholders approving the merger extinguishes the duty of care claim but not the duty of loyalty claim. And the need for enhanced scrutiny in the case of conflicted transactions with the presence of a *de jure* or *de facto* controlling shareholder brings up the “potential for process manipulation by the controlling stockholder, and the concern that the controlling stockholder’s continued presence might

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96 See *Williams v. Geier*, 671 A.2d 1368, 1381 (Del. 1996) (noting, among other things, that the joint action of the shareholders and directors may represent “the highest and best form of corporate democracy”).


98 Id. at 1196-1197.
influence even a fully informed shareholder vote”.

If no control is exercised, however, the review standard applicable is business judgment, as it was found to be in *In re Wheelabrator* case.

**D. Empty Voting and “Controlling” Shareholders**

Provided with this framework and the incentives distortion analysis performed, a *prima facie* assessment of the King-Mylan transactional features seems to lead to the entire fairness standard. However, as pointed out by the aforementioned opinions, the pivotal profile for a proper fiduciary duties’ analysis is in the relationship between any controlling or dominating shareholder (read: the HF) and the board of directors and the existence of arm’s length negotiation. Therefore, it is worthy to initiate a closer investigation of the position of the board of directors and its relationship with the HF in different contexts.

This Section elaborates on a policy response applicable to the situation in which the HF, alone or acting jointly with other funds, (i) engages in empty voting and (ii) has *de facto* control over the company and/or a specific transaction or an influence over the board of directors. Section IV.E *infra* elaborates on instead a policy response applicable to the situation in which the HF, alone or acting jointly with other funds, (i) engages in empty voting and (ii) has neither *de facto* control over the company and/or a specific transaction nor an influence over the board, but nevertheless has a “swing vote” position with respect to a specific transaction. Where the empty voter HF has not even a “swing vote” position, no policy proposal is needed because it can do no harm.

In m&a transactions involving empty voting, the behavior of the empty voter HF can vary substantially. For clarity, we can initially suppose two factual patterns: (i) the acquirer’s board (or its ISC) negotiates and sets the price and the other terms of the deal, when the HF just steps into the acquirer to make the deal go through at a price already set (“arm’s length board decision”); (ii) the HF controlling shareholder negotiates the deal and sets the price and then seeks the board approval (“conflicted HF decision”).

The “arm’s length board decision” is an easy case as it shows, by definition, a record of arm’s length negotiations and no evidence of directors’ direct interests in the deal. Here, the business judgment rule will apply. If the board has conducted and structured the transaction and has approved the merger agreement, directly or through an independent special committee, there should be “a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company”.

In these situations, the acquirer’s board decision will be covered by the business judgment presumption, unless the shareholders can show some *prima facie* evidence suggesting any influence by the controlling shareholder or any hint of self dealing (e.g., that HF has managed to appoint nominees immediately after the stock accumulation or the conflicted shareholder position by the HF, standing on both sides of the

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99 Id. at 1205.

100 See Anabtawi & Stout, *supra* note 1, at 19 (“The degree to which a shareholder controls the board has become the judicial touchstone of shareholder fiduciary duty”).

transaction). Courts should not intervene if the board independently and in good faith set the structure and price of the deal, even if the merger agreement would be approved only by the controlling shareholders (HF). Here, the HF approval should be considered just as an ex post confirmation of an independent business decision taken by the board, which is presumed to have acted in the best interests of all shareholders and maximized their value in the absence of any self-interest suggestion: even empire building allegations would not survive litigation.  

The “conflicted HF decision” scenario depicts the opposite situation and calls for an enhanced analysis. In case the controlling shareholder (HF) structured and negotiated the deal, even in a sale to a non-affiliated third party, the board of directors is nevertheless under the duty to maximize the value for all the shareholders (see above the McMullin case). Here, the risk for imposing a price that is not in the best interests of all shareholders of the acquirer would be high, if the incentives’ distortion and overpayment risk described supra in Sections III.A and III.C is taken into account. In fact, the de-coupling of voting rights and economic ownership creates an incentives’ distortion which is exacerbated by the risk of overpayment if empty voting is matched with the position of the HF standing on both sides of the transactions and having an overall negative economic ownership. This peculiar factual scenario calls for a protection of the disinterested shareholders of the acquiring company, which might be forced to pay a price too high for the acquisition of the target. Entire fairness seems to be the most appropriate standard of review in these situations.

Factual patterns between the two “artificial” extremes, arm’s length board decision and conflicted HF decision, can however include a continuum of intermediate situations. Among this continuum, the case of an empty voter HF being a de jure controlling shareholder is also an easy one. While in general terms shareholders as opposed to directors do not owe fiduciary duties, a controlling shareholder owes fiduciary duties to fellow shareholders regardless of empty voting to the extent it has “absolute control over all corporate conduct as a routine matter”. Therefore, fiduciary duties are already applicable to activist HFs which employ empty voting and are controlling shareholders.

While the HF does not seem to exercise such absolute control, as some empirical evidence suggests, the HFs have nevertheless become powerful players also in the m&a arena and might well exercise a strong influence over a formally independent board or even a de facto control over the company or a certain transaction. Influence over the board might include a solicitation from

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102 However, should an HF, alone or acting jointly with other players, have an outcome-determinative position on the deal approval and have made recourse to empty voting, some safeguards are nevertheless due. Please see Section IV.E for the relevant policy proposal.

103 See Anabtawi & Stout, supra note 1, at 21.

104 The only policy proposal applicable to this situation is that a MOM approval should trigger the business judgment rule presumption also where an HF controlling shareholder is present.

105 See Brav, Jiang, Thomas & Partnoy, supra note 17, at 5 (“Despite their frequently aggressive behavior, activist hedge funds do not typically seek control in target companies. The median maximum ownership stake for the entire sample is about 9.1 percent. Even at the 95th percentile in the full sample, the stake is 31.5 percent – far short of the level for majority control”).

106 See Anabtawi & Stout, supra note 1, at 31-32 (“Activist hedge funds’ power and influence have grown to the point where they are now targeting much larger firms, including MacDonalds, General Motors, and Time-Warner. The result is a new genre of public company shareholder that is aggressive, wealthy, and eager to play a role in setting corporate policy. In the words of one
the board itself to the HF, with the promise of a reward in exchange for a decisive “help” by the HF in the approval of a specific transaction. An example of de facto control might consist of the direct involvement of HF in the company’s management with a predominant presence on the board of directors, although in King-Mylan-type transactions the presence on the board is unlikely due to the quick acquisition of the stake by the HF. In these cases, the dealing process and/or the setting of the price might be considered tainted by an intervention of the HF, a shareholder with distorted and possibly inefficient incentives arising from empty voting.

Here, the scope of “ unholy alliances” between HFs and management is potentially wide. Even if it has been claimed that there seems to be no evidence of such alliances, the potential room for side deals is large and they might take different forms. In King-Mylan-type transactions, the “new greenmail” would take the form of an excessive overpayment in the acquisition, which would clearly constitute for the HF a very close substitute of a payment to pay its stake off in the acquirer company. This “reward” might also take the shape of different merger terms in favor of the HF. The HF could benefit from a higher ratio in the stock for stock exchange or the acquirer could make some concessions in the form of favourable contractual clauses in the merger agreement, which would be beneficial for the HF as shareholder of the target company. This reward would be the new century version of the greenmail premium extracted by corporate raiders in the 80s.

This gaming picture is completed with the powerful bargaining position of the HF. The HF can easily walk away as quickly as they stepped into the acquirer if not satisfied with the board’s response to their requests. And it is now empirically proved that the HFs are particularly able to obtain what they want. So, the HF is in the position to credibly threaten the acquirer’s management to withdraw the support of the deal: whether this threat can compromise the board’s fiduciary duties to protect the interests of the corporation and of the fellow

industry insider, because of activist hedge funds, ‘the balance of power is shifting away from boards.’) (footnotes omitted).

107 Kahan & Rock, supra note 1, at 1082 (reporting no evidence of “hedge funds and managers making a side deal . . . or, such as greenmail in which the firm pays the hedge fund to go away”). But see Anabtawi & Stout, supra note 1, at 7 (reporting the case of an investment partnership holding 45% of an environmental services company’s common stock that approach several other shareholders of the environmental services company and offer them “the opportunity to participate in unrelated business deals on highly favorable terms if they agree to vote their shares in favor of the [transaction]”. The board of directors of the environmental services company consisted of a majority of investors in the investment partnership).

108 See Partnoy & Thomas, supra note 5, at 42 (claiming that “at least in the case of strategies promoting merger activity, corporate managers have little incentive to defend against hedge fund efforts to engage in such activities. Indeed, if managers obtain private benefits from such activity, we might expect managers and hedge funds to be complicit in such strategies”).

109 Kahan & Rock, supra note 1, at 1082 (taking into account only the possibility of greenmail payment to buy the HF off, whereas side deals might occur also to attract the HF when the management needs the backing of the HF in the approval of the operation). But also Partnoy & Thomas, supra note 5, at 42 (advancing that “[u]nlike the private equity deals of the 1980s, the more recent instances of merger arbitrage are more likely to be associated with value-destroying mergers”).

110 See the results of the empirical works by Klein and Zur, supra note 12, and by Bratton, supra note 12, already discussed in detail in Section III.B supra.
shareholders or trigger a fierce reaction by the management is a case-by-case factual matter. Still, the legal issue remains. Moreover, if in the Rosenblatt freezeout case, fair dealing and fair price were achieved even with the presence of an 80% majority shareholder, fair dealing and fair price might be as well at risk with the presence of a 9.9% shareholder as the largest constituency of the company, as happened in the King-Mylan case.

If not alone, HFs may act, and sometimes they do act, together with other HFs, as a group of activist shareholders, as demonstrated by some reported cases. They seldom act as “catalyst” for activism by traditional institutions conducted jointly with, or in the wake of, HFs. Under these dynamics, the activism of a single HF, or more likely, of a group of HFs may pose credible and powerful threats to the target companies’ management or even influence the fellow shareholders.

From a policy perspective, in the presence of disinterested shareholders opposed to a controlling or at least influential shareholder with distorted incentives (the HF), the maximization of the disinterested shareholders’ values should be pursued, as already clearly indicated by the courts. As mentioned before, the maximization of the disinterested shareholders’ interests implies an assessment of the efficiency benefits entailed by the merger, discounted by the premium (costs) paid to get them, which are achieved when marginal benefits equal marginal costs. This evaluation is to be left to the disinterested shareholders, since they are the actual residual claimants armed with the right interests to pursue an efficient decision. Therefore, the involvement of the disinterested shareholders in the approval of the merger should be incentivized through an adjustment to the current review standards applicable to conflicted transactions.

In conflicted transactions, where duty of loyalty claims arise, the business practice has elaborated over time the cleansing devices of the ISC approval and of the MOM approval. Under current Delaware corporate law, the two devices have the same force. If the merger is approved either by an independent special committee or by the majority of minority shareholders, the transaction will be nevertheless reviewed under the entire fairness standard but the burden of proof will be shifted to the plaintiff shareholders to prove that the terms

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111 See, for example, the group led by Carl Ichan in the KT&G case, reported by Kahan & Rock, supra note 1, at 1024 and 1031; see also Anabtawi & Stout, supra note 1, at 31 (“[T]he 1992 proxy rule amendments have allowed funds to form ‘wolf packs’ of several funds that buy stakes in a company and together pressure its managers.”) and in general terms, Kahan & Rock, supra note 1, at 1034 (“[H]edge funds have themselves – sometimes on their own, sometimes as part of a group – tried to acquire companies.”).

112 Kahan & Rock, supra note 1, at 1045.

113 See the case reported by Anabtawi & Stout, supra note 1, at 7 (reporting an offer by a 45% shareholder to fellow shareholders to participate in unrelated business deals on highly favorable terms if they agree to vote their shares in favor of the transaction), also cited supra at note 107.

114 Kamar, supra note 38, at 6 (making pro-shareholders’ vote policy proposals dependent on whether shareholders in general and institutional investors in particular vote effectively and reporting a number of empirical studies suggesting that they do). Moreover, regardless of empty voting, the current standard of review regime applicable to merger-freezeouts has been also criticized because it is socially inefficient. See also Subramanian, supra note 76, at 39 (demonstrating that the current protective devices for minority shareholders – namely, the ISC process and the entire fairness review – “can deter some value-increasing merger-freezeout transactions”).
were unfair.\textsuperscript{115} If the transaction receives neither ISC nor MOM approval, it shall be reviewed under the entire fairness standard and the defendants should prove fair dealing and fair price.

For efficiency reasons, the two cleansing devices should not have the same force, at least in conflicted transactions involving empty voting. In particular, only the disinterested shareholders direct involvement in the decision process can guarantee that the proposed merger terms are maximizing the shareholders’ value. Therefore, the disinterested shareholders’ approval (MOM device) should trigger a business judgment presumption. An approval of the merger by a disinterested special committee (ISC device) would instead shift the burden of proof to the plaintiff to show that the transaction (dealing and price) was unfair, as it does under the current law. The disinterested shareholders’ approach, giving preference to the MOM approval over the ISC approval, clearly creates strong incentives for managers to seek the involvement of the disinterested shareholders on the approval of the merger, as it would trigger the business judgment protection.

Procedurally, the burden of proof to show (i) empty voting and (ii) \textit{de facto} control or influence over the board of directors would be on the plaintiff disinterested shareholders. Here, it should be assumed that a legislative reform would be passed imposing a disclosure obligation on the shareholder empty voter. Without disclosure requirements for empty voting, the plaintiff will likely not meet the burden to prove the existence of empty voting even where the HFs have engaged in empty voting.

This disinterested shareholders’ approach is partially different from the functional proposal of Hon. Allen, Jacobs, and Strine, which has already advanced that the business judgment presumption should be triggered either by the mentioned cleansing device or by the approval of an independent disinterested committee of the board.\textsuperscript{116} The “pure” disinterested shareholders’ approach proposed here (treating differently MOM and ISC devices) should be preferred for King-Mylan-type transactions because it is more efficient from two perspectives: it would give the decision power back to the actual residual claimants in this setting (the disinterested shareholders), and would give an incentive to the board of directors to seek the approval by the disinterested shareholders as a simple approval by the ISC would not trigger a business judgment presumption.

The disinterested shareholders’ approach is also not exactly equivalent to imposing abstention to vote on the shareholder having a negative economic ownership or entering an empty voting scheme, as already proposed.\textsuperscript{117} Under the disinterested shareholders’ approach, a merger approved by the HF but opposed by the majority of the fellow shareholders will be still possible even if open to review under the entire fairness standard. This would allow the pursuing of

\textsuperscript{115} \textit{Kahn}, 638 A.2d 1110.

\textsuperscript{116} Allen, Jacobs, and Strine, \textit{supra} note 76, at 1306; for a partially different proposal, see Subramanian, \textit{supra} note 76, at 61 (proposing, with respect to merger-freezeouts, that “the combination of an [ISC process and a MOM condition would give the controller business judgment review by the court”).

\textsuperscript{117} See Hu & Black, \textit{Empty Voting II}, \textit{supra} note 2, at 702 (imposing abstention in case of negative economic ownership and giving power to companies to amend corporate charters to disallow voting rights in case of empty voting); Martin & Partnoy, \textit{supra} note 1, at 793 (imposing abstention in case of empty voting).
transactions which would not have been approved without the votes of the HF, but which could be nevertheless value-increasing (efficient). However, the fairness of the deal will have to be proved under the enhanced standard of review of entire fairness and the deal shall be accomplished if proved to be fair.

Two more considerations are finally due. In the first instance, it must be pointed out that the disinterested shareholders’ approach will paradoxically reduce protection for shareholders if compared with the current law. Under the current regime, even a combined use of ISC and MOM devices does not trigger business judgment rule, so that this situation is considered the “worst world” fortransactional lawyers on the management side. Despite this paradoxical outcome, disinterested (and in general minority) shareholders deserve more power but, along with the power, are called to take responsibility for their actions. Secondly, a cost-saving rationale can be claimed out of the disinterested shareholders’ approach. As noted, distinction between arm’s length transactions and conflicted HF decisions is often difficult to strike, and factual patterns can be blurred with the implication of high costs for the courts in the efforts to figure out how the negotiations have proceeded. As the disinterested shareholders’ approach implies the application of the business judgment rule if MOM approval is obtained (regardless of how dealing proceeded), under this new structure, when the board of directors will obtain MOM approval, the benefits will consist also in the costs saved by the courts in the efforts to investigate the details of the dealing process.

E. Empty Voting and “Swing Vote” Shareholders

Section IV.D has addressed conflicted shareholder positions in merger transactions where the empty voter HF is supposed to have a de facto control over the company and/or a specific transaction or an influence over the board of directors. Empty voting, however, does not necessarily infer that the HFs would be able to influence or even control the board of directors’ conduct.

In this Section, I will address situations where HFs influence over the board of directors and/or a specific transaction do not exist or can not be demonstrated. In particular, I will address the situation where the HF, alone or acting jointly with other funds, (i) engages in empty voting and (ii) has neither de facto control over the company and/or a specific transaction nor an influence over the board, but nevertheless has a “swing vote” position with respect to a specific transaction. By swing vote, I mean the position pursuant to which the vote by a shareholder is outcome-determinative in the approval or rejection of some proposals at the shareholders’ meeting, most significantly for our purposes of a merger proposal.

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118 See Subramanian, supra note 76, at 17.
119 Please note that this cost saving rationale can not be applied to the policy proposal advanced by Subramanian as, under that proposal, only a combination of the ISC process and a MOM condition would trigger business judgment rule protection. See Subramanian, supra note 76, at 61.
120 See the example by Anabtawi & Stout, supra note 1, at 21 (“[S]uppose that a corporate action, such as a merger, must be approved by the vote of an absolute majority of outstanding shares. Suppose further that investors holding 49 percent of those shares oppose the merger, while investors holding another 49 percent support it. In such a case a two percent shareholder who provides the ‘swing vote’ controls the outcome”).
In these situations, where a shareholder HF engages in empty voting and has a swing vote, the risk for incentives’ distortion is still present (e.g. an incentive on overpayment on the acquirer’s side for King-Mylan type transactions), but the deal structure and price are not tainted by the influence of the activist HF. Duty of loyalty concerns arise to the extent that interested shareholders (i.e. the HFs) are able to exercise control or influence over the board of directors or a specific transaction (such as the merger proposal. When there is no prima facie evidence of control (or even influence) over the board of directors or the merger proposal by the HF, duty of loyalty issues are less likely to arise and therefore entire fairness does not seem to be the appropriate standard of review.

However, empty voting creates a deviation from the default principle one-share-one-vote and implies a separation between economic interests and voting rights, which might be exacerbated in our context by the overall negative economic ownership borne by the swing voter HF shareholder. The directors might take advantage of this fragile situation and, to stick with King-Mylan type of operations, of the overall negative economic ownership borne by the HF to overpay for the acquisition ratio so that a value-destroying (inefficient) transaction might take place. Because of the potentially strong impact on the voting machinery by the combined effect of empty voting and the swing vote, the conduct by the board of directors should be assessed under an enhanced scrutiny.

Which standard of review should be applicable where the empty voter HF has a swing vote? The disinterested shareholders’ approach clearly applies here as well. This implies that, should the relevant transaction be approved by the majority of disinterested shareholders, the review standard will be business judgment rule, in line with the proposal advanced for the case of empty voting employed by HFs shareholders who have a control or influence over the board of directors or the transaction (see Section IV.D supra).

Without MOM approval, it has been mentioned that entire fairness does not seem to be the appropriate standard of review for a transaction approved with the determining vote of a swing voter HF engaging in empty voting. Conversely, business judgment rule as it is, however, does not take into account the incentives distortion created by empty voting and the impact of HFs’ swing vote. The business judgment rule is (not a standard of conduct but) a standard of review, under which, should some conditions be met, a presumption applies that the directors “of a corporation acted on an informed basis, in good faith and in the

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121 Corporate voting machinery is strongly distorted by empty voting as pointed out by Kahan & Rock, The Hanging Chads of Corporate Voting 29-31 (Univ. of Pa. Law Sch. ILE Research Paper No. 07-18 & N.Y. Univ. Sch. of Law Research Paper No. 07-29, 2007) available at http://ssrn.com/abstract= 1007065 (labelling empty voting as one of the “pathologies of shareholders’ voting” and reporting the King-Mylan case as an example of this pathology); Martin & Partnoy, supra note 1, passim; Hu & Black, Empty Voting II, supra note 2, passim. However, the direction of the impact of empty voting on corporate voting mechanism, whether anti-management or pro-management, remains unclear.


123 See Melvin A. Eisenberg, The Director’s Duty of Care in Negotiated Dispositions, 51 U. MIAMI L. REV. 579, 579-580 (1996-1997) (“A standard of conduct states how an actor should play a given role or conduct a given function. . . . A standard of review states the test a court should apply when it reviews an actor’s conduct to determine whether to impose liability or grant injunctive relief.”).
honest belief that the action taken was in the best interests of the company”. 124 For our purposes, among the conditions to be satisfied for the application of the business judgment rule, “the director may not have a financial interest in the subject matter of the decision”. 125 On these grounds, absent any financial interest by the directors (where entire fairness should apply under current case law) and any prima facie evidence of HF control or influence over the board of directors or a specific transaction (where the proposal under Section IV.D supra should apply), in transactions where the empty voting tactic is employed by a swing vote HF shareholder, business judgment rule would be the standard of review. However, that standard should be corrected somehow to address the combined effect of empty voting and the swing vote. The peculiar structure of the burden of proof in the business judgment standard might give some hints on the possible treatment of this combined effect.

Under Delaware law, Technicolor elaborated on the presumption posed by the business judgment rule and on the related burden of proof. 126 “The rule posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be “attributed to any rational business purpose”. Thus, a shareholder plaintiff challenging a board decision has the burden at the outset to rebut the rule’s presumption. “To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty – good faith, loyalty or due care. . . . If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the “entire fairness” of the transaction to the shareholder plaintiff”. 127

In case of empty voting and HF swing vote, it might be advanced that the business judgment rule procedural prong would be corrected in that the plaintiffs disinterested shareholders will bear the burden to show just the presence of empty voting and the outcome-determinative position of the HF. 128 Should this burden be met, the presumption would be rebutted so that it would be up to defendant directors to provide evidence that they acted in an informed and deliberate manner and in good faith without breaching any one of its triad of fiduciary duties. Furthermore, should the defendant not meet this burden, entire fairness would apply and the defendant could always prove the entire fairness of the transaction to the plaintiffs.

124 Aronson, 473 A.2d at 812.
125 Eisenberg, supra note 123, at 582-83 (“[T]he business judgment rule is inapplicable to a director’s decision to approve the corporation’s purchase of its own property.”).
127 Id. at 361. More recently, the Technicolor approach has been confirmed by the Delaware Supreme Court in McMullin 765 at 916-17 (“Procedurally, the initial burden is on the shareholder plaintiff to rebut the presumption of the business judgment rule. To meet that burden, the shareholder plaintiff must effectively provide evidence that the defendant board of director, in reaching the challenged decision, breached any one of its ‘triad of fiduciary duties, loyalty, good faith or due care’) (footnotes omitted).
128 We assume here that a legislative reform would be passed imposing a disclosure obligation on the shareholder empty voter as advanced by Hu & Black, The New Vote Buying, supra note 1. Should this not be the case, the plaintiff will likely not meet the burden to prove the existence of empty voting.
The disinterested shareholders’ approach here proposed shares some features of the shareholders’ fiduciary duties theory recently elaborated by two legal scholars and applied also to empty voting. The approach to empty voting is similar in that it expands fiduciary duties obligations beyond freezeouts and close corporations, the only two contexts where corporate law traditionally imposes fiduciary duties obligations also to shareholders. Other than being a theory applicable to every kind of shareholders’ conflicts of interest, the shareholders’ fiduciary duties theory elaborated by Anabtawi and Stout is also different from the disinterested shareholders’ approach under two profiles. First, the disinterested shareholders’ approach does not imply fiduciary duties’ obligations owed by the empty voter HF shareholders to the extent that they do not exercise control over the company under the current legal doctrine. Directors’ conduct as opposed to shareholders’ conduct should be under review if the HF shareholders engaging in empty voting are not controlling shareholders. In presence of empty voting, the risk is that directors’ conduct is tainted by the combined action of the influence exercised by the HFs and their distorted incentives and therefore directors’ actions deserve enhanced scrutiny. In second instance, the disinterested shareholders’ approach makes a distinction between shareholders HFs having some influence over the board/company and shareholders having merely a swing vote, whereas Anabtawi and Stout include the swing vote position in the notion of “control” for the purposes of triggering latent duty of loyalty obligations. This expansion however seems overreaching as it potentially imposes fiduciary duties over minority shareholders holding very small interests and exercising no influence over the board/company.

As a final remark, it should be noted that this sketched proposal leaves room for further research in some areas. On the one hand, with regard to business judgment rule, a more director primacy-friendly “abstention doctrine” has been advanced in literature and it might have an impact on the burden of proof structure taken into account here. On the other hand, the policy proposal advanced here with regards to the disinterested shareholders approach has been developed from a factual template involving a merger transaction: therefore, some further research might be carried out to expand the disinterested shareholders’ approach to tender offers as opposed to mergers and even to transactions outside the m&a arena.

129 See Anabtawi & Stout, supra note 1, at 40-41 (including empty voting among the shareholders’ conflicts of interest calling for an expansion of fiduciary duty obligations to shareholders).

130 Id. at 19, 20, and 53 (discussing cases involving arguments over the notion of “controlling shareholders”). I vanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987) (holding that controlling shareholders are only those shareholders exercising “actual control” over the company); In re Cysive, Inc. Shareholders Litig., 836 A.2d 531 (Del. Ch. 2003) (finding a shareholder holding a 40% equity interest in a company to be a controlling shareholder); Kahn, 638 A.2d 1110 (finding a 43% shareholder to be a controlling shareholder); Smith v. Atl. Props., Inc., 422 N.E.2d 798 (Mass. App. Ct. 1981) (discussing the veto power and controlling position of a 20% shareholder of a closely-held corporation).

131 See Anabtawi & Stout, supra note 1, at 52 (“Any attempt to exercise influence that produces the desired result – put differently, any shareholder act that is a ‘but for’ cause of some corporate transaction or strategy – is an exercise of de facto shareholder control.”).

132 Bainbridge, supra note 122, at 109 (advocating for a business judgment rule approach more deferential to directors’ actions based on the Shlensky v. Wrigley case).
V. CONCLUSIONS

Delaware courts should not rule empty voting unlawful *per se*. In this paper, I have argued that empty voting is a lawful legal technique which allows HFs (and potentially every financial player) to play an important shareholder activist role. However, at its best empty voting presents the problem of destabilizing the voting procedure in the corporate machinery, by giving distorted incentives to HFs (the most likely players to employ this tactic). HFs have become strong players also in the corporate control arena. Anecdotal evidence suggests that they might have some influence on corporate policy decisions and, therefore, facilitate inefficient transactions. In fact, at the worst, empty voting might be used as a contributing device to structure conflicted transactions, in particular when the HF holds shares on both sides of the transaction and, as in the King-Mylan case, empties the votes in the acquiring company. When empty voting is employed, non-empty voter disinterested shareholders need particular protection. I argue that approval by the majority of the disinterested shareholders might be a suitable way to correct such distortion. The MOM device should be preferred to approval by an independent special committee of disinterested directors and should therefore trigger the business judgment presumption in order to give directors incentives to seek the disinterested fellow shareholders approval. This structure is supposed to contribute to efficiency as well, as the decision would be left to the disinterested fellow shareholders who are the actual residual claimants where empty voting is used.

In sum, I have tried to combine two different tasks under this policy structure. On the one hand, I have proposed a reconsideration of the current standards of review for conflicted m&a transaction, as some other scholars have already done. On the other hand, I have tackled the problematic issue of empty voting and analyzed it under a fiduciary duties approach in an effort to develop a suitable and efficient policy proposal that would fit the peculiar m&a setting, with particular reference to merger transactions. This paper leaves room for research towards the application of this proposal to tender offers and even outside the m&a arena.

Finally, a caveat applies. When the HF trading activity is coupled with a strong corporate position as influential shareholder, with a potential participation to the board of directors, the risk of insider trading and market manipulation is substantially increased. This seems true even without the use of empty voting. Insider trading risk arises to the extent a significant stake in the company provides access to privileged information, in particular if combined with the sophisticated nature and supposedly high bargain power of the HF. Market manipulation risk might also arise as a mirror of vigorous investment strategies by the HF. In particular, in the m&a context, some investment decisions could be interpreted as implicit or explicit threats to the company’s management; in these cases, the border between a legal and healthy disciplining behavior and a manipulative and illegally blackmailing conduct could be blurred and market manipulation becomes a critical issue.