IDENTIFYING THE LEGAL CONTOURS OF THE SEPARATION OF ECONOMIC RIGHTS AND VOTING RIGHTS IN PUBLICLY HELD CORPORATIONS

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IDENTIFYING THE LEGAL CONTOURS OF THE SEPARATION OF ECONOMIC RIGHTS AND VOTING RIGHTS IN PUBLICLY HELD CORPORATIONS

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I. EXECUTIVE SUMMARY

The legitimacy of modern corporate governance rests on the premise that, in shareholder elections, shareholders are economically motivated to vote in a manner that maximizes the value of the corporation's shares. Voting interests and economic interests are assumed to be aligned.

The rapid growth of derivative markets and of other sophisticated market techniques, however, calls this assumption into question. It is today quite easy for investors to construct portfolios that increase in value as a corporation's stock price declines while retaining the right to cast large blocks of votes in shareholder elections. A particularly simple example of such a transaction involves an instrument known as a total return equity swap. An investor who holds one million shares of a company's stock can enter into a swap covering all one million of its shares: the swap acts like an insurance contract that covers the investor's losses if the company's stock price declines, but in return requires that the investor sacrifice all its gains if the value of the company's shares increases. The investor is then indifferent as to whether the company's stock price increases or decreases, but still gets to vote its shares as though it had never entered into the swap. If the investor enters into a swap covering two million of the company's shares it would then actually earn a profit if the company's share price declined, but the investor would again be able to vote its million shares as though it held a simple, unhedged position in the company's shares. The risk then arises that the investor could be motivated to cast its vote in a manner that actually causes economic harm to the company. The assumption that voting and economic interests are aligned is then not merely severed: it is reversed.

Similarly, creditors in federal bankruptcy proceedings have the right to vote to accept or reject a Chapter 11 reorganization plan because it is presumed to be in a creditor's interest to maximize the value of the bankruptcy estate. Creditors can, however, also enter into derivative market transactions that generate incentives to force companies into bankruptcy or to reduce the value of certain instruments in the bankrupt's estate. In other words, the simple fact that an investor is a creditor is no longer an invariably reliable signal that the investor is seeking to maximize the value of its interest in the estate: it might instead be using the voting power it gains as a creditor in order to maximize the value of a derivative instrument unknown to the bankruptcy court or to the bankrupt entity.

These phenomena have been dubbed "empty voting" when a shareholder/creditor has the formal right to more votes than indicated by its economic exposure, and "negative voting" when a shareholder/creditor profits from a decline in the value of the instruments that generate its voting rights. Professors Henry Hu and Bernard Black, the leading scholars working in this field, have identified more than 80 examples of such "decoupling" worldwide as of 2008.

Concerned by the corporate governance and real economy implications of these developments, the Investor Responsibility Research Center Institute ("IRRC Institute"), whose mission is to provide thought leadership at the intersection of corporate responsibility and the informational needs of investors, provided a research grant to the Rock Center for Corporate Governance at Stanford University to conduct a review of the academic review of the literature in this field, and to survey judicial decisions and statutory provisions that relate to the challenges posed by the decoupling phenomenon. The goal of this survey is to assist market regulators and policy makers in their understanding of the issues.

This Report begins by summarizing 19 research papers written on the subjects of equity and debt decoupling and empty or negative voting. The Report then proceeds to analyze provisions of federal securities law that are potentially implicated by these practices but that fail to account for the possibility of decoupling transactions. The Report also surveys the literature to identify policy-relevant proposals for addressing these potential challenges, as well as critiques of certain of these proposals.

The Report then addresses the Dodd-Frank Act of 2010, with particular focus on the Act's reporting requirements for swap contracts, as well as the challenges posed by the potential for empty voting in the context of the SEC's recently adopted proxy access rules. The Report further considers the Commission's opportunity to address these concerns in conjunction with the Commission's "Proxy Plumbing" concept release.

The Report also catalogues implications of decoupling and of empty or negative voting in the context of the Chapter 11 federal bankruptcy process, and describes a range of potential remedies that have been proposed in the academic literature. The report concludes with a summary of four seminal judicial opinions addressing empty voting issues in the context of Delaware corporate law, federal securities law, and bankruptcy law. These opinions indicate that concerns over decoupling transactions and empty or negative voting are in fact beginning to emerge in litigated transactions.

Our findings can be summarized as follows:

- The potential for and reality of decoupling transactions that can generate empty or negative voting can present significant challenges to existing shareholder and creditor governance practices.

- Existing disclosure provisions in federal securities law and federal bankruptcy law assume that the economic rights and voting rights associated with share or debt ownership are inseparable. Because these rights may now be freely decoupled, existing law fails to provide necessary transparency as to the existence of hedging transactions that can affect the economic rights and voting incentives of shareholders and creditors. As a result, other stakeholders,

including other shareholders, creditors, corporate directors and regulators may not have the information they need to make informed decisions.

- It is unclear that disclosure alone is sufficient to address the problems that can be created by empty and/or negative voting. Policy makers may therefore wish to consider substantive measures that might address the rights of shareowners or creditors to cast votes without regard to their participation in decoupling transactions that can give rise to empty or negative voting.

II. INTRODUCTION

Who has the right to vote in an election and why?

In most political processes, voting rights depend on "citizenship." If you are a citizen of a state or of a municipality, and satisfy certain other qualifications, such as age minima or residency requirements, you may then have the right to vote in local elections. If you are not a citizen then you have no voting rights in the local election. The logic is simple. If you live in the district then you presumably have an interest in promoting the local district's best interests: you will care about the quality of schools, the effectiveness of local police and fire protection, the costs of providing those services, and myriad other considerations that affect your life and the lives of your neighbors. If you don't live in the district, then you won't have the same incentives, and won't be allowed to vote in the district's elections.

Much of the same logic applies in corporate elections. There, stock ownership is viewed as the equivalent of "citizenship." If you own stock in the corporation, then it is assumed that you have an interest in maximizing the value of the corporation's shares. You will also care about corporate policies governing executive compensation, approval of mergers, election of directors, and many other factors that influence the value of your shares. Voting rights are therefore typically allocated to the corporation's shareholders precisely because they have an incentive to act in a manner that maximizes the value of the corporation's shares.[1] Further, the larger the number of shares an investor owns, the larger the investor's stake in the corporation's success. Voting rights are therefore usually, but not invariably, proportional to the size of the investor's shareholding.[2]

But what if innovations in financial technology sever the link between share ownership and the incentive to maximize the value of the corporation's shares? What if modern financial market transactions make it trivially easy for shareholders to structure their portfolios so that they actually earn larger profits if the corporation's shares decline in value? In that event, a shareholder may technically qualify as a "citizen" of the corporate community with full voting rights, but may have an incentive diametrically opposed to the objectives pursued by more traditional shareholders who seek to maximize the value of their shares.

More modestly, what if modern financial markets make it trivially easy for shareholders to structure their portfolios so that their shareholdings are no longer proportionately related to their economic exposure to the firm's fortunes? Thus, a shareholder owning two percent of the corporation's stock, and two percent of the firm's voting power, might

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[1] *See, e.g.*, Robert C. Clark, Corporate Law 389 (1986) ("The intuition behind this argument is that giving control to the [shareholders] will place the power to monitor the performance of participants in the firms and the power to control shirking, waste, and so forth in the hands of those who have the best incentive to use the power.").

[2] Super-voting and non-voting shares are the most common exceptions to this norm.

have a much smaller exposure to the corporation's financial performance than a shareholder with a one percent position, or even a shareholder owning only a quarter of a percent of the corporation's shares.

The reality is that modern capital markets do make it trivially easy to dissociate formal share ownership, and the concomitant voting rights, from a proportionate economic interest in the value of the corporation's shares. Whether these transactions take place in the form of swaps, forwards, futures, puts, or calls, the result is the same: the fundamental assumption that underlies the shareholder voting mechanism is called into question. The political analogy is simple: it is as though a voter is allowed to move out of the district yet is still permitted to vote in local elections because the voter maintains a local mail drop.

Courts have historically expressed concern over these potential conflicts through the doctrine of "vote buying." "[C]ourts closely scrutinize vote buying because a shareholder who divorces property interest from voting interest [ ] fails to serve the community of interest among all shareholders, since the 'bought' shareholder votes may not reflect rational, economic self-interest arguably common to all shareholders."[3] The Securities and Exchange Commission also recognizes that its own proxy rules are based on the "foundational understanding that, absent contractual or legal provisions to the contrary, a "shareholder" possesses both voting rights and an economic interest in the company."[4] The Commission further recognizes that the ability to "decouple" formal share ownership from a proportionate economic stake in the corporation's success "challenges this foundational understanding."[5]

Similar issues arise in the bankruptcy process. There, bondholders are presumed to have economic interests that are proportionate to their debt holdings. Thus, in bankruptcy court, bondholders can be assigned to committees and obtain significant influence over the restructuring process precisely because of the size of their debt holdings. These same bondholders can, however, enter into derivative market transactions that give them economic incentives that are not correlated with their bond holdings. In the extreme, an investor can enter into a series of credit derivative swap transactions that promise very large returns if a publicly traded firm declares bankruptcy. The same investor can, however, own that corporation's debt and use that debt position to agitate for an involuntary bankruptcy. Other, more complex strategies, can be designed, for example, to favor some debt holders over others, and are facilitated by

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[3] *In re IXC Communications, Inc. Shareholders Litigation*, 1999 WL 1009174 at *8 (Del. Ch. Oct. 27, 1999). *See also*, *Haft v. Haft*, 671 A.2d 413, 421 (Del. Ch. 1995) ("A very powerful argument can be advanced that generally the congruence of the right to vote and the residual rights of ownership will tend towards efficient wealth production.").

[4] United States Securities and Exchange Commission, Concept Release on the U.S. Proxy System, Rel. No. 34-62495, 75 Fed. Reg. 42982, 43017 (July 22, 2010), *available at* http://www.sec.gov/rules/concept/2010/34-62495.pdf.

[5] *Id.*

modern derivative market transactions that allow debt investors to decouple their economic interests from their formal ownership of a corporation's debt.

A general intuition that animates the concern over empty voting is based on the long tradition of property rights. If you own something, you get to decide what to do with it. There might be questions about true ownership, government power to interfere with property, or limits on harms to others created by your property, but the intuition that people can decide what to do with their property has been a part of the American system for as long as there has been an American system. The emergence of decoupling transactions, however, raises the counter-intuitive prospect of being able to control property as to which the shareholder or creditor is not fully exposed, and thus does not, in the traditional sense, "own."

Empty voting thus pressures the traditional intuition by blurring the lines of what truly represents "ownership," and even "property." Furthermore, the kind of ownership involved in "empty voting"— consisting, as it does, of power to determine policy affecting other co-owners — is, by its very nature, an exercise of collective ownership. When different constituencies within that collective have starkly different incentives, but cannot view or understand the incentives in each case, there is a potential for abuse within the system.

Not all commentators view these developments as potentially threatening. For example, some scholars observe that modern financial markets can make it possible for informed shareholders to acquire disproportionately large voting positions from less informed shareholders in a manner that improves electoral outcomes and enhances shareholder value.[6] If these transactions dominate the marketplace, then modern capital market transactions that facilitate the separation of formal stock ownership from the allocation of voting rights could improve the efficiency of the corporate voting process.

But regardless of whether one views these developments as a welcome innovation or a threat to the established system, the reality is that the law has not kept pace with financial market reality. The current legal regime evolved in response to a more primitive form of vote buying than the "empty voting" system described in this report. Whatever the virtues or vices of "empty voting," it is decidedly uncontroversial that the law has not yet responded to the new financial realities that "empty voting" represents.

This Report, which was made possible by a grant from the IRRC Institute, takes no position on the social welfare implications of financial market transactions that facilitate the separation of formal share ownership from corporate voting rights. It seeks instead to summarize and review the relevant literature in a manner that illuminates the controversy and furthers reasoned analysis of the challenges presented by the decoupling of the formal ownership of equity or debt instruments from the economic

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[6] *See, e.g.*, Susan E.K. Christoffersen, Chistopher C. Geczy, David K. Musto, and Adam V. Reed, *Vote Trading and Information Aggregation*, 62 J. Fin. 2897 (2007).

exposure traditionally represented by those ownership interests. The Report also seeks to identify statutory and regulatory provisions that assume, expressly or by implication, that voting rights and economic interests are positively and proportionately related.

This inquiry is, we suggest, particularly timely in light of: (1) the recent passage of the Dodd-Frank Act, which significantly increases scrutiny of derivative market transactions; (2) the Securities and Exchange Commission's recent adoption of proxy access regulations which measure voting power largely without regard to shareholder's ability to decouple formal voting rights from economic interests; and (3) the Commission's recent issuance of its "proxy plumbing" release which raises probing questions about the implications of decoupling for the corporate governance process. The confluence of two other initiatives, combined with the increased sophistication of derivative market transactions, underscore the significance of the policy issues raised by decoupling or empty voting.

Viewed from this perspective, it is also valuable to observe that the ability to separate formal legal ownership from economic interest has been part of the corporate landscape for many decades. In particular, the right to vote a corporation's shares is determined by record ownership weeks or months prior to the actual date of the election. There is no legal requirement that a record shareholder continue to hold its position through the date of the election. Thus, a shareholder with, say four percent of a corporation's voting power as of the record date could sell all its shares prior to the date of the election, and establish a large short position, so that by the date of the election it could promote its economic interests by advocating a position that would depress the value of the corporation's shares. However, because it was the holder of record of four percent of the corporation's shares, as of the record date, the shareholder continues to be able to vote all its shares. The evolution of modern derivative market transactions may facilitate the ability to decouple formal ownership of equity and debt interests from the economic interests represented by those ownership positions, but these modern derivative market transactions are not necessary to create the decoupling phenomenon, or to raise the concerns addressed in the review.

III. LITERATURE REVIEW

The literature related to coupling or empty voting has grown rapidly in recent years. We bifurcate our reviews of that literature into articles that address equity and debt markets, and describe that literature sequentially within each category.

A. Separation of Voting Power from Economic Ownership in Equities and Implications for Corporate Governance

1. Martin and Partnoy, "Encumbered Shares," University of Illinois Law Review (2005)

In 2005, Shaun Martin and Frank Partnoy published an article that examined the background and history of the "one share/one-vote" rule and concluded that the assumptions underlying this rule were no longer valid in light of the possibility and reality of empty voting.[7] The "one share/one vote" regime is at the heart of what is now called shareholder primacy, a norm that has received ample backing in state and federal corporate law, and throughout the markets. "One share/one vote," as explained originally by leading corporate law theorists Frank Easterbrook and Daniel Fischel and recharacterized by Martin and Partnoy, "properly allocate[s] voting rights in ways that minimize agency costs and mimic the rules for which shareholders and other corporate constituents would contract absent transaction costs."[8] This theory assumes that "shareholders are granted voting rights and have such rights in direct proportion to the number of shares held because of agency costs considerations. Shareholders have 'similar if not identical' preferences as to their desires for the firm and are collectively the group with appropriate incentives to make discretionary decisions because they 'receive most of the marginal gains and incur most of the marginal costs' attributable to those decisions."[9]

Thus, under the one share/one vote conception, shareholders receive voting rights simply because doing so maximizes the value of the firm in a way that could not occur if voting rights were given to employees, creditors, or other constituents.

Martin and Partnoy challenge the presumption underlying the rule of "one share, one vote" in two principal ways. First, they identify shareholders who are, in their term, "economically encumbered." That is, shareholders who have hedged their share ownership through the purchase of a short, or by use of other derivatives, such as a put, or a credit-default swap.[10] Such shareholders have lost the pure economic benefit of

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[7] Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. Ill. L. Rev. 775 (2005).
[8] *Id.* at 776
[9] *Id.* at 776 (citing Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & Econ. 395, 403, 405 (1983)).
[10] *Id.* at 780.

the shareholding and will therefore lack the same incentives as those shareholders who own the stock without any kind of hedge.[11] Martin and Partnoy's preliminary conclusion is that, contrary to the presumption underlying the rule of "one share/one vote," "corporations and their regulators should strongly consider taking away the votes of option buyers and sellers."[12]

Martin and Partnoy also consider the opposite question of whether voting rights should be granted to persons who, through derivatives, have acquired an economic interest in a company without acquiring shares. They acknowledge the argument that such persons "have not purchased any stake in the corporation and therefore should not be involved in its governance,"[13] and proceed to observe that such persons may under some circumstances be more appropriate voters than encumbered shareholders precisely because their interests are more closely aligned with traditional conceptions of shareholder incentives.[14]

2. Hu and Black, "Decoupling Trilogy"

The most exhaustive commentary in the area of decoupling and empty voting has been provided by Professors Henry T.C. Hu and Bernard Black, who over the course of 2005 and 2006 published a series of three papers targeted at different audiences. Their first paper, "The New Vote Buying: Empty Voting and Hidden Ownership,"[15] was directed at legal academics. Their second paper, "Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms,"[16] published in the *Business Lawyer*, was targeted towards lawyers, judges, and regulators. The third and final paper in the initial series, "Hedge Funds, Insiders, and Empty Voting: Decoupling of Economic and Voting Ownership in Public Companies,"[17] was directed towards finance academics.

Hu & Black's thesis was that rapid growth and increased sophistication in the derivatives markets, combined with the growth of hedge funds and other capital market developments, made it far easier for both outside investors and corporate insiders to "decouple" the economic rights of shares from the voting rights associated with those shares. As a result, the presumption that shareholders will vote in a way that they

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[11] *Id.* at 794.
[12] *Id.* at 794.
[13] *Id.* at 804.
[14] *Id.* at 805.
[15] 79 S. Cal. L. Rev. 811 (2006)(hereinafter referred to as "Decoupling I (Law Review Version)"). *See* Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions,* 156 U. Pa. L. Rev. 625 (2008).
[16] Henry T. C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 Bus. Law. 1011 (2006)(hereinafter referred to as "Decoupling I for Lawyers").
[17] Bernard Black & Henry Hu, *Hedge Funds, Insiders, and Empty Voting: Decoupling of Economic and Voting Ownership in Public Companies*, 13 J. Corp. Fin. 343 (2007) (hereinafter referred to as "Decoupling I (Finance Version)").

believe will maximize their return on investment and add to the value of the corporation to them is called into question.

Hu & Black defined several terms associated with this phenomenon and because they help promote clarity and precision in describing various phenomena in the market, we set them out before proceeding:

- *Ownership:* Shareholder possession of both the economic return on shares and corresponding voting power.
- *Economic Ownership:* The economic returns associated with share ownership.
- *Formal Voting Rights*: The legal right to vote shares under company law, including the legal power to instruct someone else how to vote.
- *Empty Voter:* A shareholder that, through hedging or other transactions, has the formal right to more votes than its economic ownership.
- *Negative Economic Owner*: A shareholder whose hedges exceed its share ownership.
- *Hidden (Morphable) Owner:* A shareholder who holds more economic ownership than votes, with the *de facto* ability to acquire the votes if needed.
- *Decoupling:* Refers to the separation of voting rights from economic exposure, and can refer to both empty voting and hidden (morphable) ownership.[18]

As one of the first examples of empty voting observed in practice, Hu & Black described the matter of *Perry/Mylan*[19]:

> "A recent public U.S. instance of empty voting illustrates the potential risks from empty voting. 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. When the deal was announced, King's shares soared, but Mylan's shares dropped sharply. To help Mylan receive shareholder approval for the merger, Perry bought 9.9% of Mylan—becoming Mylan's largest shareholder—but hedged its market risk on the Mylan shares. Perry thus had a 9.9% *voting ownership* but zero *economic ownership.* Including its position in King, Perry's overall economic interest in Mylan was negative**.** The more Mylan (over)paid for king, the more Perry would profit."[20]

Hu & Black then described an example of hidden (morphable) ownership in another matter that also involved Perry Corp.

> "Conversely, investors can have hidden ownership—economic ownership that is not disclosed because the investor has shed the formal voting rights that trigger disclosure but with the *de facto* ability to acquire votes quickly when needed.

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[18] *See, generally*, Hu & Black, *supra* note 16.
[19] *High River Ltd. P'ship v. Mylan Labs., Inc.,* 353 F. Supp. 2d 487 (M.D. Pa. 2005).
[20] *Decoupling I (Finance Version)* at 346.

> Perry's stake in a New Zealand company, Rubicon Ltd., which came to light in 2003, illustrates New Zealand's large shareholder disclosure rules, like Section 13(d) under U.S. law, requires disclosure by 5% shareholders. Perry used equity swaps to hold both an undisclosed 16% economic stake in Rubicon and *de facto* rights to 16% of the votes: Perry had a 16% hidden *voting* ownership. When an important election came along, Perry arranged for the *de facto* voting rights to morph into actual voting rights. The non-disclosure of Perry's 16% stake was upheld under New Zealand law."[21]

Characterizing these as examples of "new vote buying," Hu & Black proceeded to identify approximately 20 known or "publicly rumored" instances of "new vote buying" that they were able to ascertain as of the date of their paper.[22] In their series of papers, Hu & Black went on to discuss the implications of empty voting and hidden (morphable) ownership. They further analyzed the then-current disclosure regime under U.S. federal law, and proposed a series of reforms directed at short-term enhancement of disclosure and longer-term strategies based on: (1) potential voting rights limitations in empty voting situations; (2) voting architecture; and (3) supply and demand forces. As with the other papers to be discussed, we address proposed reforms in Section II of this analysis.

3. Katz, "Barbarians At The Ballot Box: The Use Of Hedging To Acquire Low Cost Corporate Influence And Its Effect On Shareholder Apathy," Cardozo Law Review (2006)[23]

Shortly after the publication of the Decoupling Trilogy, an article on the potential for hedge funds to use decoupling strategies "to acquire low-cost corporate influence" was published in the Cardozo Law Review. This work was published too early to discuss in detail the approach and terminology of the Decoupling Trilogy but did recognize it in a footnote as "tremendously interesting and insightful."[24] Its title is strongly suggestive of the views of the author, who was concerned about the potential for hedge funds to "acquire significant voting influence, yet maintain no underlying economic interest in the corporation, and use that voting influence to force [a] transaction through, thereby locking in their projected profits."[25]

In that vein, the author examined the *Perry/Mylan* matter and Carl Icahn's legal challenge that sought to enjoin Mylan from holding its shareholder vote and Perry from exercising the voting rights it had acquired.[26] However, the subsequent discovery of accounting irregularities at King led Mylan to drop its efforts to acquire King and Icahn to

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[21] *Decoupling I for Lawyers* at 5.
[22] *Decoupling I (Law Review Version)* at 848-849.
[23] Jonathan J. Katz, *Barbarians At The Ballot Box: The Use Of Hedging To Acquire Low Cost Corporate Influence And Its Effect On Shareholder Apathy*, 28 Cardozo L. Rev. 1483 (2006).
[24] *Id.*
[25] *Id.* at 1486-1487.
[26] *Id.* at 1504.

abandon his suit. The author notes that as of the release of his paper, "this type of hedging transaction, designed solely to influence shareholder elections, has not been subjected to judicial scrutiny, although the SEC had issued a Wells notice indicating the potential for an enforcement action."[27]

Unlike Hu & Black, Katz did not examine the share ownership disclosure regime under federal securities laws. Instead, Katz focused on federal provisions regulating short sales and Delaware corporate law prohibiting "vote buying." Katz observed that the primary "dangers" of hedging to gain influence were: (1) the potential adverse effect on the value of stock prices because part of the value of share ownership for large shareholders is a "control premium" and the use of hedging to gain corporate influence negates the influence of large shareholders and therefore the value of stock ownership to those shareholders; and (2) an erosion of the already-diminished incentive for shareholders to exercise their voting rights due to a belief that hedge funds are "stacking the deck" and leading shareholders "to feel helpless to influence corporate policy."[28] The author's position is that these dangers are sufficient to warrant hedging transactions designed to influence shareholder elections to be deemed void, either through a narrowing of the Delaware vote-buying standard and/or federal regulatory change in the area of short-selling.[29]

4. Kahan and Rock, "Hedge Funds in Corporate Governance and Corporate Control," University of Pennsylvania Law Review (2006)[30]

In an Article that otherwise focuses on hedge fund activism in general, Kahan and Rock characterize the problem of "New Vote Buying" discussed by Hu and Black as "an example of an old problem—conflicts of interest created by exploiting the separation of legal and beneficial ownership—aggravated by modern financial instruments[31]. The focus again was on *Perry/Mylan*, and the authors noted that while Perry's actions appeared to be a form of "vote buying," Hu & Black had explained that the actions are not prohibited by the current regulatory structure.[32] Kahan and Rock posited that if "empty voting turns out to be a significant problem—and it is not clear that it will—new measures will be required, either through regulation or by common law decision making."[33] The authors did agree with Hu & Black that not enough was yet known about the extent of empty voting to warrant more than increased disclosure.[34]

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[27] *Id.* at 1505.
[28] *Id.* at 1515-1517.
[29] *Id.* at 1517.
[30] Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. Pa. L. Rev. 1021 (2007).
[31] *Id.* at 1075-76.
[32] *Id.* at 1076.
[33] *Id.*
[34] *Id.* at 1077.

5. Lee, "Empty Voting: A Private Solution To A Private Problem," Columbia Business Law Review (2007)[35]

Michael Lee, a student from Columbia Law School, examines existing Delaware law on empty voting, and subsequently proposes private sector solutions to the empty voting problems. Lee first examines *Deephaven v. UnitedGlobalCom,*[36] a case questioning the ability of "economically empty" shareholders to seek inspection rights under Delaware Code Ann. Tit. 8, §220. The defendant corporation argued that shareholder inspection rights should not be available to shareholders who held net short positions in the corporation.[37] The court ruled for the shareholder, comparing the positions of the shareholder to those of a bank customer who had both a deposit with and loan from the bank. Lee observed that the court distinguished §220 inspection rights from voting rights, reasoning that "unlike in other situations such as voting, the §220 [inspection rights] analysis includes its own safeguard against plaintiffs with economic incentives that are not aligned with other stockholders: the proper purpose analysis."[38] Lee opined that this language "clearly indicates the court's willingness to intercede in situations lacking safeguards against distorted economic incentives, and in voting contexts in particular."[39]

Lee then moved on to discuss Delaware's vote-buying doctrine, noting that Delaware defines vote-buying as "any transaction by which a party directs a shareholder's vote for consideration personal to that shareholder."[40] In Lee's view, "empty voting does not fit neatly within that definition, since the empty voter is typically selling a separated economic stake rather than buying a separate vote."[41] Lee nevertheless, concluded that the policy underlying vote-buying prohibition was just as applicable to empty voting, observing that "if the applicability of vote-buying doctrine turned on who had the unsevered share to begin with, it could easily be avoided by arranging every vote-buying agreement as a two-step process."[42]

After analyzing other Delaware vote-buying cases, Lee concluded that Delaware vote-buying doctrine would prevent empty voting where it would dictate the outcome of a vote or where it is done by management in breach of fiduciary duty.[43] Lee reasoned that the only empty voting situation not covered by Delaware law was one in which empty shares are voted by a shareholder against the interests of the remaining shareholders.

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[35] Michael Lee, *Empty voting: Private Solutions to a Private Problem*, 2007 Colum. Bus. L. Rev. 885 (2007).
[36] No. Civ.A. 379-N, 2005 WL 1713067 (Del. Ch. 2005).
[37] Lee, *supra* note 35, at 886.
[38] *Id.*
[39] *Id.*
[40] *Id.* at 887, citing *IXC Communications*, 199 WL 1009174 at 8.
[41] *Id.* at 887, citing Nathan, *Empty Voting" and Other Fault Lines Undermining Shareholder Democracy: The New Hunting Ground for Hedge Funds*, 1571 PLI/CORP 425, 437 (2006).
[42] Lee, *supra* note 35, at 888.
[43] *Id.* at 897.

After analyzing the potential concerns presented by this practice, Lee ultimately concluded that while regulatory and legal changes could be helpful, several "self help" solutions were available to the corporations themselves. One example he cited, to which we will later return, is amending the charter to require shareholder disclosure of leveraged voting positions.[44]

6. Kahan and Rock, "The Hanging Chads of Corporate Voting," Georgetown Law Journal (2008)[45]

Kahan and Rock followed their work on hedge fund activism with a paper exploring "the incredibly complicated system of U.S. corporate voting."[46] They attribute the complexity to the custodial-ownership structure, dispersed ownership, large trading volumes, and to the rise in short-selling and derivatives. Kahan and Rock suggested that there are "three ways in which things predictably go wrong: pathologies of complexity; pathologies of ownership; and pathologies of misalignment between voting rights and economic interest."[47] "Empty voting" is identified as an example of the interest misalignment pathology.[48] They characterize empty voting as "an esoteric and theoretically interesting pathology" and observed that it has also been called "encumbered shares" by Martin and Partnoy.[49] Although they referenced the *Perry/Mylan* case, the authors declined to discuss it in detail, in part because they were "uncertain of its real world significance, at least in the United States."[50] They did observe, however, that:

> "Intentional empty voting has different, and more disconcerting, ramifications than incidental discrepancies. In economic effect—albeit not in legal structure[51]--it resembles vote buying. An investor who goes out of its way to buy votes is likely to vote the shares, and because that investor decided to divest its economic interest in the company, it may well vote them in a manner that reduces the value of the company. (Footnote omitted). Intentional empty voting, to the extent it occurs, will thus tend to result in systematically inferior voting outcomes.[52]

Kahan and Rock also discussed "overvoting" as a pathology of ownership, which has become a growing concern due to widespread securities lending and short selling

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[44] *Id.* at 907.
[45] Marcel Kahan & Edward B. Rock, *The Hanging Chads of Corporate Voting,* 96 Geo. L.J. 1227 (2008).
[46] *Id.*
[47] *Id.*
[48] *Id.* at 1265.
[49] *Id.* (citing Martin & Partnoy, *Encumbered Shares,* 2005 U. Ill. L. Rev. 775 (2005)).
[50] *Id.* at 1265.
[51] In a footnote, Kahan and Rock make similar contrast between vote buying and empty voting as Lee did, noting that "Vote buying traditionally involves an acquisition of votes without an acquisition of an economic stake. Empty voting typically involves an acquisition of shares—vote plus stake—and a separate transaction to divest the economic stake. *Id.* at 1267, fn. 159.
[52] *Id.* at 1267.

practices. To understand overvoting, it is helpful to understand how nominee shares are voted. A large majority of U.S. investors hold their securities positions through one or more securities intermediaries, typically brokers. The brokers who hold shares in street names would then solicit voting instructions from their clients, the beneficial owners of the shares. With respect to short sale transactions, a broker may lend shares held in its clients' margin accounts to short sellers, but the lender broker typically does not reconcile its records to reflect that it no longer has the vote of the loaned securities.[53] As a result, if the loaned securities are not returned on or before record date, both the borrower and the lender may attempt to submit a vote for the same securities. Even if the borrower does not attempt to vote, a discrepancy would arise if the lender broker communicates to the vote tabulator more votes than its clients are technically entitled to register. Essentially, overvoting is a mechanical problem where a securities intermediary seeks to cast more votes than the number of shares that the intermediary actually holds. That in turn would "tend to raise the number of shares being voted, but if proper adjustments are not made, overvoting can lead to a wholesale disqualification of votes [under Delaware law] and thus to fewer shares being effectively voted."[54]

7. Hu & Black, "Equity and Debt Decoupling and Empty Voting II: Importance and Extensions," University of Pennsylvania Law Review (2008)[55]

In early 2008, Hu & Black returned to the issue of empty voting. In this article (hereinafter referred to as "Decoupling II") they identified more than 80 examples of decoupling arising in more than 20 countries.[56] Based on their findings, they declared that "one share, one vote" and that the presumption that ownership of shares is a meaningful concept conveying a standard package of shareholder rights "works no longer" because the "derivatives revolution in finance, the growth of sophisticated, lightly regulated hedge funds, and the related growth of the share lending market now make it easy to decouple voting rights from economic ownership."[57]

In this paper, Hu & Black expanded their recommendations for disclosure reform and identified potential responses beyond disclosure, including amendments to corporate law that would allow charter amendments limiting empty voting and an example of such an amendment that would require large shareholders to attest to non-empty voter status. Significantly, they introduce the concept of "debt decoupling," situations in which creditors, such as bond holders hedge their holdings to reduce or eliminate their economic exposure and become "empty creditors."[58] Hu and Black expand upon this

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[53] *Id.* at 1258-1262.
[54] *Id.* at 1269.
[55] Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. Pa. L. Rev. 625 (2008).
[56] *Id.* at 630.
[57] *Id.* at 632-33.
[58] *Id.* at 728.

concept in a related paper focused on debt decoupling discussed at greater length in Section I (B) of this working paper.

Hu & Black also addressed the increasingly serious problem of overvoting, as identified by Marcel Kahan, Edward Rock and other scholars. To reduce this problem, Hu & Black proposed that broker-dealers be required to implement internal procedures so that they know how many votes they hold and how many voting instructions they have received.[59] The authors also suggested that (i) limitations be imposed on share lending by record owners to prevent overvoting and (ii) in the case of an overvote, applicable state law be amended to treat a record owner as voting the number of shares it is entitled to, with yes, no, and abstain votes reduced proportionately.[60]

8. Cohen, "Negative Voting: Why it Destroys Shareholder Value and a Proposal to Prevent it," Harvard Journal on Legislation (2008)[61]

This comment examines the *Perry/Mylan* matter from the perspective of the negative economic interest that Perry had in the movement of Mylan's stock price. The note observes that Perry was insulated from a downward movement in Mylan shares if the merger went through but would benefit from the corresponding increase in King Pharmaceutical shares. Following a review of the rationale for the general proscription against vote-buying, the author's view is that of all the forms of the new "vote-buying" identified by Hu and Black, negative voting had the "most potential to create inefficiencies" of the type that traditional vote-buying prohibitions were intended to prevent.[62] The author went on to state that:

> "…negative voting is more troubling than the other forms of the new vote buying: non-negative empty voting and hidden (morphable) ownership. While a case can be made that deviations from 'one share, one vote" should be permitted if the interests of third party shareholders are sufficiently protected, negative voting clearly fails this test, as negative voters have the financial incentive to harm third party shareholders to the greatest degree possible."[63]

The author proceeds to analyze current federal disclosure rules and concludes that they do not adequately cause disclosure of negative voting positions. He then reviews three proposals that would address empty voting concerns and deems them either overbroad or insufficient to address negative voting concerns. Of Hu and Black's proposal for a significant expansion of disclosure, he suggests that the cost would be significant and

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[59] *Id.* at 711 (commenting that a regulatory push is necessary because brokers may have insufficient incentives to do so on their own).
[60] *Id.* at 696-697.
[61] Jonathan Cohen, *Negative Voting: Why it Destroys Shareholder Value and a Proposal to Prevent It*, 45 Harv. J. on Legis. 237 (2008).
[62] *Id.* at 239.
[63] *Id.* at 242.

that it was insufficient to deter negative voting.[64] Of another proposal to disqualify empty voters from voting,[65] Cohen argues that it would require that courts become much more involved in corporate governance and would be overreaching in curtailing beneficial instances of non-negative voting.[66] Of Hermes' proposal to disallow voting by borrowers of shares, Cohen notes that this prohibition would not address negative voting by owners of purchased shares and would alter the proxy process by requiring share lenders to take action to prevent proxies being delivered to share borrowers.[67]

The author proposes instead that a private right of action be created so that shareholders harmed by the negative voting of another shareholder can sue that shareholder. He describes the process as follows:

> "A plaintiff would establish standing by proving it possessed beneficial ownership of the relevant stock at the time of the shareholder vote at which the negative voting is alleged. Once the burden is met, the plaintiff would need to show (1) that the defendant was in fact a negative voter and (2) that the defendant cast votes in a way that caused harm to the plaintiff."[68]

Cohen suggests that the proposal could be adopted at either the state or federal level. He analyzed at some length the question of whether the SEC could adopt such a provision by rule, ultimately concluding that such an effort might be invalidated by the courts and instead suggesting the creation of a private right of action by a federal or state legislative body.

9. Dombalagian, "Can Borrowing Shares Vindicate Shareholder Primacy?" U.C. Davis Law Review (2008)[69]

Dombalagian posits that empty voting could be beneficial because it could empower institutional shareholders to take steps to improve corporate governance. The author contends that the "new" vote buying made possible by the use of derivatives and /or securities lending differs from traditional – and prohibited vote buying because: (1) the transactions at issue typically involve activist shareholders rather than insiders and controlling shareholders; and (2) the transactions are "not necessarily motivated by a desire to extract benefits at the expense of public shareholders," but instead may have benefits such as reducing the cost of shareholder decision making or facilitating control contests in the face of opposition.[70]

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[64] *Id.* at 250-51.
[65] *Id.* at 252 (citing the article entitled "Behind the Hedge" by David Skeel, as published in the November/December 2005 edition of Legal Affairs).
[66] *Id.*
[67] *Id.* at 253.
[68] *Id.* at 254.
[69] Onnig H. Dombalagian, *Can Borrowing Shares Vindicate Shareholder Primacy?*, 42 U.C. Davis L. Rev. 1231 (2009).
[70] *Id.* at 1258-1259.

Observing that regulating empty voting would "require financial regulators to roll back much of the deregulatory initiatives of the past decade,"[71] and that a new regulatory framework would be "cumbersome and largely ineffective,"[72] the author proceeds to examine whether empty voting should instead be viewed in a positive light. In his view,

> "…empty voting need not be dismissed as undesirable if it is designed to promote corporate transactions that increase social wealth and if auxiliary mechanisms exist to ensure that shareholders are not treated unfairly (vis-à-vis other stakeholders or third parties who may wish to purchase votes). In other words, I argue that empty voting is not detrimental to social wealth if (i) a "significant" percentage of institutional shareholders are committed to maximizing the long-term wealth of the individual firms in which they invest; (ii) those institutional shareholders are empowered to borrow empty votes in opposition to or in support of, and on equal (or better) terms with, insurgents; (iii) the fiduciary duties of these institutional shareholders to their clients, and the manner in which they communicate and consult with the firms in which they invest, are re-imagined in a way to give them sufficient incentive to buy votes; and (iv) courts continue to scrutinize transactions effected with the use of empty votes and intervene in instances of substantial unfairness to affected shareholders."[73]

The author concludes that "[I]f a stable institutional market for borrowing public shares were to emerge from the gray market for 'empty votes,' it would serve as a vindication for shareholder primacy in public share markets."[74] In Dombalagian's view, the alternative is less shareholder involvement in the governance process.

10. Cunningham, "Examination of Judicial Policy on Corporate Vote Buying in the Context of Modern Financial Instruments," NYU Annual Survey of American Law[75]

After summarizing *Perry/Mylan* in context of vote-buying theory and examining the methods available to facilitate empty voting as well as the available evidence regarding the widespread nature of the practice, the author expressed concern about the potential for abuse. He observes that:

> "If that abuse remains unchecked it represents a substantial threat—not just to individual companies, but to the market for corporate control as a whole. Part of the seriousness stems from the radical degree to which empty voting, and the

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[71] *Id.* at 1262.
[72] *Id.* at 1263.
[73] *Id.* at 1273.
[74] *Id.* at 1311.
[75] Kevin C. Cunningham, *Examination of Judicial Policy on Corporate Vote Buying in the Context of Modern Financial Instruments*, 64 N.Y.U. Ann. Surv. Am. L. 293 (2008).

new vote buying generally, eviscerate long-held assumptions underlying corporate voting theory."[76]

The author reviews the support for the traditional principle assuming the coupling of economic and voting rights, examines this assumption in light of the development of empty voting methods, and concludes that the assumption is no longer valid. Examining the potential market for "decoupled votes," the author notes that a serious concern exists with the pricing of such votes given that the value of a vote could vary dramatically given whether that vote was outcome-determinative or not.[77] Like Martin and Partnoy,[78] the author observes that empty voting also is at odds with traditional corporate voting theory that assumes a unity of shareholder interests.[79]

This paper proceeds to examine case law underlying the traditional prohibition against vote buying with a particular focus on the lead Delaware Chancery decision in *Schreiber v. Carney*.[80] The analysis includes a relatively brief discussion of the obstacles that would be faced by the SEC, state legislatures, and individual corporations in dealing with empty voting issues and concludes that state courts "will almost certainly be the venue that initially adjudicates debate over empty voting, whether this is optimal from an institutional competency perspective or not."[81]

The judicial solution favored by the author is the development of a "robust intrinsic fairness test." According to the author, acquisition of a voting share includes a reasonable expectation of a proportional claim on the share's value and the ability to "dictate, in proportion to the ownership claim, the choice of the 'community of interest." [82] The author believes that empty voting is at odds with this principle, and should be subject to a judicial review for fairness.

11. Thompson and Edelman, "Corporate Voting," Vanderbilt Law Review (2009)[83]

This paper primarily examines the role of shareholder voting in modern corporations. After discussing the theory, purpose and history of voting generally and corporate voting specifically, [84] the author sets forth an alternative theory of shareholder voting. His theory is predicated on the notion of "error correction," *i.e.*, that "the best signal for identifying board error is the stock price and that shareholders are the constituency with

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[76] *Id.* at 302-303.
[77] *Id.* at 306.
[78] *See* text accompanying notes 7 to 14, *supra.*
[79] Cunningham, *supra* note 75, at 307.
[80] *Id.* at 309-330 (discussing *Schreiber v. Carney,* 447 A.2d 17 (Del. Ch. 1982).
[81] *Id.* at 330-335.
[82] *Id.* at 337-38.
[83] Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 Vand. L. Rev. 129 (2009).
[84] *Id.* at 132-153.

the most incentive to monitor that signal."[85] Accordingly, voting plays an important but limited role in corporate governance and is not plenary but instead is targeted and best suited to issues such as replacing entrenched directors who are blocking a value-increasing transaction and/or blocking an "empire building merger" proposed by directors and managers. In the authors' view, shareholder nominations for director, as well as matters subject to precatory voting, are less important. [86]

The author reviews the literature concerning empty voting, and concludes that in order for shareholder voting to be effective there must be alignment between the interest of the vote and the collective interests of shareholders. Empty voting is, in the authors' view, at odds with that principle.[87] The author questions whether disclosure provisions would be sufficient to address this concern and proposes that shareholders, either through statutory change or judicial rule, be "required to certify that they are voting no more shares than they have economic interests in."[88]

12. Sullivan, "CSX Corp. v. Children's Investment Fund Management and the Need for SEC Expansion of Beneficial Ownership," North Carolina Law Review (2009)[89]

Sullivan addresses *CSX v. Children's Investment Fund Management (UK) LLP,*[90] an important case analyzing the concept of "beneficial ownership" under federal securities law as applied to equity swap transactions. As the author notes in this paper, the *CSX* court determined that a hedge fund investor holding long positions on CSX shares through the use of certain total return swaps in fact beneficially owned the shares under Section 13(d) of the Exchange Act. The CSX court based its decision on the fact that the hedge fund had influence over its counterparties' voting and disposition of the CSX shares and that it used swaps with an intention to conceal its aggregation of a substantial economic interest in CSX.[91]

The author contends that the court's decision was contrary to the existing language of the SEC's rules concerning the definition of "beneficial ownership." He further argues that the SEC, and not the courts, is the proper authority to expand the scope of Rule 13d-3's beneficial ownership definition to include interests derived from equity swaps.[92]

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[85] *Id.* at 149-150.
[86] *Id.* at 166-172.
[87] *Id.* at 153-156.
[88] *Id.* at 165-166.
[89] Brian T. Sullivan, *CSX Corp. v. Children's Investment Fund Management and the Need for SEC Expansion of Beneficial Ownership*, 87 N.C.L. Rev. 1300 (2009).
[90] 562 F. Supp. 2d 511 (S.D.N.Y. 2008).
[91] *Id.* at 1310-1315. Part VI-B of this working paper further examines the relevant holdings in *CSX* and its underlying factual background.
[92] *Id.* at 1316-1319.

13. Karmel, "Voting Power Without Responsibility or Risk – How Should Proxy Reform Address the Decoupling of Economic and Voting Rights?," Villanova Law Review (2009)[93]

This paper correctly predicted that the SEC would enact a rule providing for some measure of shareholder access to the proxy during the Obama administration.[94] According to the author, the problems associated with empty voting will be exacerbated if the SEC adopts such a rule without first addressing the issues presented by empty voting.[95] She notes that while empty voting "seriously undermines" the shareholder franchise, empty voters had not yet been deprived of the ability to vote their shares either by state or federal law.[96]

With respect to the issue of proxy access, the author recommended that the SEC eliminate empty voters from the definition of shareholder eligible to nominate directors on the ballot.[97] She also recommends that the SEC amend Forms 13D, 13G and 13F to provide for enhanced disclosure of empty and hidden voting positions. She notes that in any proxy access rule, the SEC could then require a shareholder representation that they have had continuous *economic* ownership during the required holding period, and not merely formal record ownership.[98]

14. Frankel, "The New Financial Assets: Separating Ownership from Control," Seattle University Law Review (2010)[99]

This examination of decoupling issues includes an extensive discussion of Hu and Black's work and of the *CSX* litigation. Among the developments cited are the actions taken by two companies, Sara Lee and Coach, to protect themselves from empty voting by enacting bylaw changes that require shareholders that submit ballot proposals to identify any hedging activity with respect to company shares.[100] The author states that addressing the potential harms of decoupling activity does not always require more regulation but instead necessitates the enforcement of the current law. For example, the author posits that the deleterious effects of empty voting could be successfully addressed in many circumstances by judicial enforcement of existing sanctions against vote buying.[101] The author does argue, however, that regulation of derivative over-the counter markets should be tightened.[102]

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[93] Roberta S. Karmel, *Voting Power Without Responsibility or Risk—How Should Proxy Reform Address the Decoupling of Economic and Voting Rights?*, 55 Vill. L. Rev. 93 (2010).
[94] *Id.* at 95.
[95] *Id.* at 94.
[96] *Id.* at 93.
[97] *Id.* at 96.
[98] *Id.* at 122-123.
[99] Tamar Frankel, *The New Financial Assets: Separating Ownership from Control*, 33 Seattle L. Rev. 931 (2010).
[100] *Id.* at 943-944.
[101] *Id.* at 952.
[102] *Id.* at 953.

B. Separation of Voting Power from Economic Ownership in Debt Instruments and Implications for Bankruptcy Proceedings

1. Partnoy and Skeel, "The Promise and Perils of Credit Derivatives," University of Cincinnati Law Review (2007)[103]

Partnoy and Skeel appear to be first in the academic legal literature to address the possibility that a creditor that hedges its economic position may have an incentive to use its position to affirmatively destroy value in a bankruptcy proceeding. This paper, which was written as an in-depth examination of credit derivatives, preceded the 2008 global market meltdown and the resulting scrutiny of these instruments. The authors cite several benefits and problems associated with credit default swaps and collateralized debt obligations. In the bankruptcy context, they analyzed the matter of *Tower Automotive*, an auto industry supplier that was seeking approval from its lenders to adjust terms of existing loans in order to facilitate a new loan that would allow the company to avoid bankruptcy. While the bank creditors were amenable to these concessions, hedge funds that owned a portion of the debt refused to consent, and as a result, the company was forced to file for bankruptcy.[104] The authors note that the rumored explanation for the hedge funds intransience was that they had shorted the company's stock and therefore stood to profit if the value of the company's stock declined as a consequence of the bankruptcy.

The authors then reviewed the *Perry/Mylan* matter and posited that:

> "…a lender that has purchased credit default swaps may have an incentive to use its position as a lender to affirmatively destroy value. A hedge fund or other lender that will benefit more if the company defaults than if it successfully averts default may become, in a sense, a Darth Vader monitor. Such lenders have a financial incentive to actively enforce the terms of their lending agreements. But they profit by forcing the company to default, even if a default will destroy value, not by helping to improve its governance."[105]

2. Lubben, "Credit Derivatives And The Future of Chapter 11," American Bankruptcy Law Journal (2007)[106]

Leading with Alan Greenspan's particularly prescient comment that "[cr]edit default swaps are becoming the most important instrument I've seen in decades,"[107] this 2007

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[103] Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. Cinn. L. Rev. 1019 (2007)
[104] *Id.* at 1034.
[105] *Id.* at 1035.
[106] Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 Am. Bankr. L.J. 405 (2007).
[107] *Id. at 405.*

paper addresses the potential impact of the growth of the credit derivative market on Chapter 11 bankruptcy proceedings. Similar to the concerns expressed by Partnoy and Skeel, Lubben observes that credit derivatives "may ultimately discourage out-of-court restructurings or at least place artificial time limits on the length of such negotiations, while simultaneously increasing the incidence of involuntary bankruptcy filings."[108] Lubben bases this concern on the time-limited nature of most credit default swaps, noting that the holders of these instruments face a risk that a pre-filing workout may not be resolved prior to the swap's expiration. Thus, as the maturity date of the swap approaches, the creditor will be increasingly less likely to work with the debtor, and may in fact have an incentive to file an involuntary bankruptcy petition against the debtor.[109] The author suggests that one possible response to this possibility would be to amend either the Bankruptcy Code or the Federal Rules of Bankruptcy to require a petitioning creditor to disclose swap positions.[110]

The author is no less sanguine about the potential impact of credit default swaps in a Chapter 11 bankruptcy proceeding, noting their potential to "exacerbate creditor conflicts."[111] The author observes that restructuring negotiations in Chapter 11 are commonly led by the largest creditors and resulting agreements are then submitted to all creditors for approval. As the largest creditors are, in the author's view, the most likely to be hedged, they may agree to "riskier reorganization terms or other similar terms that result solely from the downside protection these large bondholders have by virtue of their swap positions, exacerbating the potential difference of interests between large and small creditors."[112]

Ultimately, however, the author strikes a moderate note. He observes that "It has long been the case that chapter 11 cases contain creditors whose voting power far exceeds their 'true' stake in the proceedings,"[113] and suggests that while courts should be aware of the potential for riskier plans, "they should not necessarily seek to stop it."[114]

3. Hu & Black, "Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications," European Financial Management (2008)[115]

As discussed earlier, at the time they published Decoupling II, Hu & Black discussed the extension of empty voting principles to the debt/bankruptcy field.[116] In this companion paper (hereinafter referred to "Debt, Equity and Hybrid Decoupling") they observe that:

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[108] *Id.* at 427.
[109] *Id.*
[110] *Id.*
[111] *Id.* at 428.
[112] *Id.*
[113] Id at 429.
[114] *Id.*
[115] Henry T.C. Hu & Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 Eur. Fin. Mgmt. 663 (2008).
[116] *See* text accompanying note 55, *supra.*

"[j]ust as shareholders can hedge their economic exposure by holding equity derivatives and other coupled assets, creditors can often hedge through credit derivatives and other coupled assets."[117] "Empty creditors" maintain formal contractual control rights and legal rights but have hedged their economic risk. As such, Hu and Black observe that empty creditors in a bankruptcy proceeding who are not timely paid can file an involuntary petition to put the debtor company in bankruptcy, participate in the proceedings, vote on a reorganization plan and potentially present such a plan to the court.[118] These challenges arise against a backdrop of a far larger debt decoupling market than that which exists for equity decoupling and under a bankruptcy process that involves far less disclosure than arises in securities markets regulated by the SEC.[119]

Hu & Black point out that through decoupling mechanisms, creditors with such rights can have negative economic ownership just as is the case in equity markets. Those creditors would have the control and legal rights associated with debt ownership but may nevertheless be motivated to cause the debtor company to fail.[120] While they cite no examples of this occurring, they state that they have been advised by bankruptcy judges "that they sometimes see odd behavior in their courtrooms, which empty crediting might explain."[121] One example they discuss is a case in which "…a junior creditor complained that the firm's value was too *high*, even though a lower value would hurt the class of debt the creditor ostensibly held."[122]

Borrowing from their recommendations on the equity side, Hu & Black suggest that one response to this issue would be to require disclosure in bankruptcy of "significant disparities between nominal debt holdings and actual economic exposure."[123] If such disclosure is made, Hu and Black state that bankruptcy courts may have the power, under Bankruptcy Code §1126, to "disregard or limit votes by empty creditors."[124]

4. Sandler and Coniglio, "Decoupling Issues in Bankruptcy," American Bar Association Business Law Newsletter (2008)[125]

This brief paper builds upon the work of both Lubben and Hu & Black, describing further implications of decoupling in bankruptcy proceedings. The authors observe that the potential for decoupling leaves debtors "in the awkward position of not knowing the identity of the true creditor-in-interest."[126] A debtor may reasonably assume that a

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[117] Hu & Black, *supra* note 115, at 680.
[118] *Id.*
[119] *Id.* at 679.
[120] *Id.* at 682.
[121] *Id.*
[122] *Id.*
[123] *Id.* at 684.
[124] *Id.*
[125] Bradford J. Sandler & Kari Coniglio, "*Decoupling" Issues in Bankruptcy*, American Bar Association Business Law Newsletter, *available at* www.abanet.org/buslaw/newsletter/0078/materials/pp4.pdf.
[126] *Id.* at *3.

creditor is interested in promoting the debtor's success, only to find that the creditor instead wants to see debtor fail, with the debtor having no knowledge of the creditor's actual motives. A significant point made by the authors concerns the formation of the creditors' committee. As the authors note, this committee has the authority to investigate the debtor and participate in the formulation of a plan of reorganization.[127] The authors observe that:

> "Without knowledge that a protected creditor has no incentive to act in the best interests of the estate as a whole, the United States Trustee may select a protected creditor to be a member of the committee, even though such a creditors exposure is significantly less than the other secured creditors and even though such a creditor may wish a different, if not contrary, result from the other unsecured creditors."[128]

As a solution, the authors recommend amendment of the Bankruptcy Code and/or Rules to require disclosure of any credit default swaps or other similar instruments used to decouple economic and voting rights, together with a penalty for failure to make such a disclosure that could include disallowance or subordination of a protected claim.

5. Beck, "Cashing In At The Debtor's Expense: How Total Return Swaps Can Alter Creditor Voting Incentives In A Chapter 11 Bankruptcy," Texas Tech Law Review (2009)[129]

In this comprehensive examination of the issues raised in Chapter 11 bankruptcy proceedings by creditors who have partially or fully hedged their ownership of company debt, the author summarizes the Chapter 11 process[130] and then proceeds to a discussion of credit derivatives generally and credit default swaps ("CDS") and total return swaps ("TRS") specifically. The author suggests that CDSs, unlike TRSs, do not create problems in Chapter 11 bankruptcy because bankruptcy is almost always a "credit event" that terminates the CDS and requires the parties to "settle up." The author notes that as a result, "the voting incentives traditionally coupled with the claim revert back to the party that physically holds the underlying interest."[131]

Conversely, the author points out that a TRS provides protection against the loss in value of the underlying asset and will live on in the event that the underlying issuer of a bond files for bankruptcy.[132] As a result, in the event of a bankruptcy the bondholder will be a creditor of the debtor and can vote on the plan of reorganization, but the TRS may

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[127] *Id.* at *4.
[128] *Id.*
[129] John D. Beck, *Cashing in at the Debtor's Expense: How Total Return Swaps Can Alter Creditor Voting Incentives in a Chapter 11 Bankruptcy*, 41 Tex. Tech. L. Rev. 1275 (2009).
[130] *Id.* at 1279-1283.
[131] *Id.* at 1284.
[132] *Id.* at 1286.

cause the interest and motives of such a creditor to be at significant variance from that assumed by the debtor or court.[133]

Because bankruptcy law assumes that creditors will act in their best interests to maximize their return on their claims, it further assumes that creditors will exercise their voting right in a way that maximizes their financial recovery. As the author notes, these assumptions are reflected in the self-policing nature of the responsibilities of creditors to prevent abuse of the process.[134] The potential for a creditor to have entered into a TRS to be incentivized to see the value of the bankruptcy estate to be decreased, instead of increased threatens the disruption of the bankruptcy process.[135]

The author observes that the ultimate judicial response to protect the bankruptcy process from these effects is to "designate" a creditor whose vote in accepting or rejecting a reorganization plan was not cast in good faith or in accordance with the provisions of the Bankruptcy Code pursuant to §1126(e). The result of this action is that the votes of the designated creditor are not considered in the decision to accept or reject the plan.[136] However, the author also recognizes that because voting is such a fundamental right, designation is "the exception, not the rule, "[137] and that the courts should examine other options that protect the process while not eliminating the creditor's vote. As alternatives, the author identifies: (1) creating a separate class for the creditor[138]; (2) using claims under contract law in a manner that would result in the noncreditor counterparty to the TRS to police potential abuses by the creditor;[139] (3) allowing the noncreditor counterparty to the TRS to vote the claim because its interests are more aligned with traditional creditors; [140] and (4) doing nothing and allowing the empty creditor to vote unless the creditor sells enough bonds post-petition to convert the TRS into a naked swap, but maintains enough of its claims to control the reorganization process.[141] In the authors view, limiting the designation of the creditor pursuant to §1126(e) to this set of circumstances is appropriate because it would demonstrate "the most egregious economic incentive while also evidencing some post-petition misconduct on the part of the debtor as required by case law."[142]

IV. EQUITY DECOUPLING AND EMPTY VOTING UNDER FEDERAL SECURITIES LAWS

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[133] *Id.* at 1286-1287.
[134] *Id.* at 1287.
[135] *Id.*
[136] *Id.* at 1288 (citing Bankruptcy Code §1126(c) and (d)).
[137] *Id.* at 1297 (citing *In re Adelphia,* 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006)).
[138] *Id.* at 1297-1299.
[139] *Id.* at 1299.
[140] *Id.* at 1300.
[141] *Id.* at 1301.
[142] *Id.* at 1302.

We turn now to an examination of selected provisions of the Securities Act, the Exchange Act and the Investment Company Act, some of which assume, expressly or implicitly, that voting rights and economic interests are positively and proportionally related. This Section also explores the implications of the Dodd-Frank Act's enhanced disclosure requirements with respect to the empty voting issue.

A. The Securities Act

The Securities Act of 1933 (the "Securities Act")[143] regulates the offer and sale of securities in the primary markets with two basic objectives: (1) requiring that investors receive material information concerning securities being offered for public sale; and (2) prohibiting deceit, misrepresentations, and other fraud in the sale of securities. Although often referred to as the "truth in securities" law, the Securities Act does not enhance transparency in the *secondary market*, where secondary trading of registered securities and derivatives gives rise to the problems of interest misalignment and empty voting.[144] In fact, prior to the recent enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Securities Act excluded "securities-based swap agreements" from the definition of a "security."[145] It also excluded from regulation under the Commodity Exchange Act a wide range of over-the-counter derivatives transactions between qualifying counterparties.[146] As a result, equity swaps and the issue of empty voting largely escaped the scrutiny and regulation of the SEC and the Commodity Futures Trading Commission (the "CFTC").[147] Between 2000 and 2010, the SEC did not have the authority to promulgate rules imposing reporting or recordkeeping requirements, procedures or standards as prophylactic measures against fraud, manipulation or insider trading with respect to securities-based swap agreements. However, as further discussed below, the Wall Street Transparency and Accountability Act of 2010, which is Title VII of the Dodd-Frank Act, grants both the CFTC and the SEC broad authority to regulate, respectively, most swaps and security-based swaps transactions. This regulatory development holds the potential of providing needed transparency in this area.

B. The Exchange Act

Disclosure by 5% Beneficial Owners: Section 13(d); Schedule 13D

Section 13(d) of the Securities Exchange Act of 1934 (the "Exchange Act") aims to

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[143] *See* The Laws That Govern the Securities Industry, *available at* http://www.sec.gov/about/laws.shtml#secact1933

[144] To the extent that an issue of publicly traded securities holds certain derivative position, those positions may be subject to periodic disclosure depending on their materiality and a variety of other considerations.

[145] 15 U.S.C. § 77b-1(a) (2006).

[146] Colleen M. Baker, *Regulating the Invisible: The Case of Over the Counter Derivatives*, 85 Notre Dame L. Rev. 1287, 1316 (2010)

[147] *Id.* (examining the consequences of the Commodity Futures Modernization Act of 2000).

inform shareholders of a public company about potential changes in corporate control. Any person who "directly or indirectly" acquires "beneficial ownership" of more than 5% of a public company's shares must file a Schedule 13D with SEC to disclose said ownership.[148] Section 13(d)(1)(a) further requires disclosure of information concerning the "nature of the beneficial ownership." While one may interpret this provision to require disclosure of hedging activity related to the acquired shared, Schedule 13D does not expressly mandate such disclosure. Similarly, while Section 13 (d)(1)(e) requires disclosure of "any contracts, arrangements, understandings or relationships (legal or otherwise)" relating to any securities of the issuer, including "option arrangements, calls, and puts," it is unclear whether security based-swap agreements and other synthetic arrangements that empty securities of economic ownership fall within Section 13 (d)(1)(e) disclosure requirement, and if so, the extent of disclosure required.[149] There are no interpretative releases on this question. Further the SEC in its *Perry/Mylan* decision did not address Rule 13(d) ramifications of the nondisclosure of the hedging activity that enabled empty voting. However, in *CSX*, the SEC's Division of Corporate Finance in an *amicus* letter expressed the view that a standard cash-settled equity swap agreement in itself does not confer on the long party any voting power and, thus, does not confer beneficial ownership.[150]

The Dodd-Frank Act amends Section 13(d)(1) to provide that certain security-based swaps (those having characteristics to be specified by SEC rulemaking) may be deemed to constitute beneficial ownership for purposes of required disclosure of acquisitions of greater than 5% beneficial ownership interests and quarterly reporting by institutional investment managers. The SEC now has express authority to require disclosure of security based swap agreements and other synthetic arrangements that empty securities of economic ownership through further rulemaking. Rulemaking in this area could (1) categorize different types of securities-based swaps, (2) require disclosure of some and (3) specify that reporting be promptly updated to reflect changes in the level of economic ownership of the beneficially-owned shares changes (for example, upon the entrance into or exit from a swap agreement that affects the economic ownership in the holding).

Disclosure by "Passive" Investors: Section 13(g) and Form 13G

Hu & Black also discussed the interplay of disclosure under Section 13(d) and 13(g) of the Exchange Act. Certain institutional investors who invest "passively" (in the ordinary course of business and without intent to influence control) can file a more abbreviated Schedule 13G instead of 13D. This filing is made on an annual basis, generally on February 15, based upon positions held as of December 31 of the preceding year. While both 13D and 13G filers must report the number and percentage of shares beneficially owned, and any purchases or sales within the past sixty days, there is no requirement

[148] Exchange Act § 13(d)(1), 15 U.S.C. § 78m(d)(1).
[149] Hu & Black, *supra* note 16, at 1042-.
[150] *See, generally*, Part VI-B, *infra*.

similar to that in 13(d) with respect to disclosure of "contracts and arrangements.[151] As Hu & Black point out, in *Perry/Mylan*, Perry initially determined that no disclosure of its acquisition of 9.9% of Mylan's shares was required until a 13G filing would be made on February 15 of the following year. Perry subsequently filed a 13D after Carl Icahn filed his own 13D indicating an intent to acquire Mylan, which Perry opposed.[152]

The potential availability of a 13G filing to a shareholder who has acquired more than 5% of a company's stock and has hedged the economic interest in all or some part of such holding, is problematic. The premise of Section 13(g) is that a passive investor who does not have control intent and is investing in the ordinary course of business should not be subject to the more frequent and stringent reporting requirements of 13(d). But the presence of hedging activity that eliminates the economic rights associated with the ownership of that stock suggests that such ownership may not be in "the ordinary course of business," as initially contemplated by Congress when it adopted the Exchange Act, i.e., is not made as a passive investor intending to profit from a long-term investment and to exercise the voting franchise appurtenant to that investment. A potential solution identified by Hu & Black is to require 13D reporting if a position is held with a view towards affecting a shareholder vote, even if the vote does not affect control.[153]

Disclosure by Institutional Money Managers: Section 13(f)(1) and Form 13F

Section 13(f)[154] requires that every institutional money manager, including hedge funds, that exercises investment discretion with respect to accounts holding equity securities described in Section 13(d)(1) must disclose their holdings at the end of each quarter by filing Form 13F no later than forty-five days after the end of each quarter. Form 13F requires disclosure when institutional investment managers hold $100 million or more in "Section 13(f) securities," which are generally limited to common shares and exchange-traded options of U.S. public companies. Form 13F thus requires no disclosure of securities that are not publicly traded (*e.g.*, OTC options), even if they are economically equivalent to Section 13(f) securities (e.g., exchange traded options). Money managers also need not report options they have written rather than bought. Long share positions are reported, while short positions are not. Share lenders report owning the shares, but share borrowers report nothing.

However, the Dodd-Frank Act amends Section 13(f) to expressly grant the SEC the authority, in order to prevent fraud and manipulation, to establish position limits on security-based swaps. Furthermore, in its recent audit report, the SEC Office of Inspector General comments that because derivatives and other investment vehicles are not required to be reported on Form 13F, the public cannot obtain a complete

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[151] Hu & Black, *supra* note 16, at 1041.
[152] *Id.* at 1042-43.
[153] Hu & Black, *supra* note 15, at 846.
[154] 15 U.S.C. § 78m(f).

picture of all significant investment activities of institutional investment managers.[155] The report then recommends that the SEC Division of Investment Management consider expanding the definition of Section 13(f) securities.[156] With securities-based swaps now included under the Exchange Act definition of "securities," the SEC should be able to add equity swaps to the list of the securities that must be reported pursuant to Section 13(f)(1). If implemented in a manner consistent with the Inspector General's report and the Dodd-Frank Act, future SEC rulemaking in this area likely results in greater consistency with respect to institutional money managers' reporting of their economic exposures.

Disclosure by Officers, Directors and 10% Shareholders: Section 16, Rule 16a-1, Forms 3, 4 & 5

Section 16 mandates disclosure for officers, directors, and 10% shareholders of U.S. public companies. The 10% ownership threshold is based on beneficial ownership in the Section 13(d) sense, which focuses on voting or investment power rather than economic ownership.[157] However, if disclosure is triggered, the positions disclosed are based on "beneficial ownership" under Section 16, which is defined broadly to include any "pecuniary interest," unlike 13(d).[158]

The relevant forms (Forms 3, 4, and 5) require disclosure of most economic interests, including "any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security."[159] Thus, exchange-traded and OTC swaps and derivatives must be disclosed, whether physically or cash-settled. And the derivative's value need not precisely track share value so long as its value is "derived from the value of an equity security." So "broad-based" index options, futures, and market baskets of stocks are excluded, but derivatives whose value is based on a narrow index are covered.

Hu & Black are of the view that for purposes of disclosure of "empty voting" that is based upon share ownership hedged by derivatives, Section 16 requires adequate disclosure.[160] Additional corporate disclosures of hedging transactions, in accordance

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[155] Office of Inspector General, Report No. 480, pp. 25-26 (Sept. 27, 2010).
[156] *Id.* at 27. The report states that the SEC official has been relying on a third party to prepare the list of Section 13(f)(1) securities and that no SEC division or office conducts any review of the list for accuracy and completeness before it is posted on the SEC's website every quarter. In addition, "despite Congressional intent that the SEC would be expected to make extensive use of the Section 13(f) information for regulatory and oversight purposes, no SEC division or office conducts any regular or systematic review of the data filed on Form 13F." *Id.* at 6-9.
[157] Rule 13d-3(a) defines "beneficial ownership" as the "power to vote, or to direct the voting of, [a] security; and/or … the power to dispose, or to direct the disposition of, [a] security." 17 C.F.R. § 240.13d-3(a) (2006).
[158] 17 C.F.R. § 240.16a-1, a-2.
[159] 17 C.F.R. § 240.16a-1(c).
[160] Hu & Black, *supra* note 16, at 1046.

with SEC regulation to be adopted pursuant to the Dodd-Frank Act, may provide for further disclosure in this area.

Persons Soliciting Proxies: Section 14 and Regulation 14A.

Any person who solicits proxies from public shareholders must with file with the SEC and distribute to shareholders information in a proxy statement. Item 5 of Schedule 14A requires disclosure of the registrant's (or company's) securities directly or indirectly beneficially owned and securities "own[ed] of record but not beneficially."[161] Beneficial *and* record ownership must therefore be disclosed.

Item 5 also requires disclosure of "contract[s], arrangements or understandings with any person with respect to any securities of the registrant, including, but not limited to joint ventures, loan or option arrangements, puts or calls, guarantees against loss or guarantees of profit, division of losses or profits, or the giving or withholding of proxies."[162] However, as is the case with respect to Rule 13d, there is ambiguity as to whether security based-swap agreements and other synthetic arrangements that empty securities of economic ownership fall within this category and if so, what is the extent of disclosure required.

Shareholder Proposals--Section 14, Rule 14a-8

Rule 14 addresses when a company must include a shareholder's proposal in a proxy statement. As discussed in Section II-E below, the SEC recently adopted Exchange Act Rule 14a- mandating that, shareholders acting together will be eligible to have their nominees included in the proxy materials if they own at least 3 percent of the company's shares continuously for at least the prior three years. The current eligibility provisions of Rule 14a-8 further require that, in order to be eligible to submit a proposal, a shareholder must have continuously held at least $2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for at least one year as of the date the proposal is submitted, and the shareholder must continue to hold those securities through the date of the meeting.[163]

While the rule imposes a holding period requirement, the rule does not take into account the possibility that record ownership of the shares may have been emptied of economic value through a decoupling transaction. This raises two questions: (1) whether the rule should be amended to require disclosure of any hedging activity by the proposer that reduces or eliminates the proposer's economic exposure to the stock; and (2) whether

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[161] *See* Schedule 14A - Information Required in Proxy Statement, *available at* http://taft.law.uc.edu/CCL/34ActRls/rule14a-101.html.
[162] *Id.*
[163] *See* "SEC Adopts New Measures to Facilitate Director Nominations by Shareholders," SEC Press Release 10-155 (August 25, 2010), available at http://www.sec.gov/news/press/2010/2010-155.htm

the rule should be amended to prevent so-called "empty" owners from submitting shareholder proposals.

At least two public companies have deemed the potential for empty owners to file shareholder proposals to be a problem serious enough to warrant bylaw changes. Sara Lee Corporation amended its bylaws in 2008 to require disclosure of ownership hedges or short positions held by the proposer of a shareholder proposal that would elect a new board member or could "alter the path of the company's business."[164] Similarly, Coach's bylaws now require the disclosure of any hedging activities by a shareholder be disclosed when a proposal is submitted.[165]

C. Investment Company Act

The Investment Company Act of 1940 governs activity by mutual funds and other investment companies. Mutual funds typically report to the SEC quarterly on their portfolio holdings and provide a summary list semiannually to investors. The basic forms for mutual fund disclosure are Forms N-1A, N-CSR, and N-Q. By limiting investment in the funds to selected qualified investors only, hedge funds often rely on Section 3(c)1 or Section 3(c)7 exemptions to avoid these reporting requirements.

Investment Company Act § 2(a)(36), 15 U.S.C. § 80a-2(a)(36); § 3(a)(2), 15 U.S.C. § 80a-3(a)(2); Form N1-A, 17 C.F.R. § 274.11A.

According to Hu & Black, mutual fund reporting is similar to insider reporting in that it (1) focuses on economic ownership, (2) covers all positions, both long and short, whether

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[164] Sara Lee's by-laws provide that when a shareholder nominates a director or desires to bring other business before the meeting, it must set forth information that include:

> "whether and the extent to which such shareholder, Proposed Nominee or Stockholder Associated Person, directly or indirectly (through brokers, nominees or otherwise) is subject to or during the last six months has engaged in any hedging, derivative, or other transaction or series of transactions or entered into any other agreement, arrangement, or understanding (including any short interest, any borrowing or lending of securities or any proxy or voting agreement), the effect of which is to (x) manage risk or benefit of changes in the price of Company Securities for such stockholder, Proposed Nominee or Stockholder Associated Person, or (y) increase or decrease the voting power of such stockholder, Proposed Nominee or Stockholder Associated Person in the Corporation disproportionately to such person's economic interest in the Company Securities."

[165] Frankel, *supra* note 99, at 943-44. Coach's by-laws provide that when providing advance notice of stockholder nominees for director and other stockholder proposals, the proposer must disclose:

> "whether and the extent to which any hedging or other transaction or series of transactions has been entered into by or on behalf of, or any other agreement, arrangement or understanding (including any short position on any borrowing or lending of shares of stock) has been made, the effect or intent of which is to mitigate loss to or manage risk of stock price changes for, or to increase the voting power of, such stockholder or any such Stockholder Associated Person with respect to any share of stock of the Corporation." *Id.*

or not they convey voting rights, and (3) covers exchange-traded and OTC derivative positions. According to Hu & Black, there are no rules defining the details to be reported for equity swaps and other OTC derivatives.[166]

However, we were unable to locate statutes or regulations clearly mandating disclosures of OTC derivatives and equity swaps. The only potentially relevant provisions we could locate were in Form N1-A: Items 16 (requiring a description of the investment strategy and fund policies); Item 22(b) (requiring disclosure of the rights of any authorized securities of the Fund other than capital stock); Item 27 (requiring disclosure of securities of unaffiliated issuers) and Exhibits (requiring disclosure of other material contracts not made in the ordinary course of business.) Mutual funds generally make derivatives-related disclosures to meet Form N1-A requirements. However, in a July 2010 letter to the investment community, the Office of Legal and Disclosure of the SEC observes that certain generic derivatives-related disclosures by some funds are of limited usefulness for investors in evaluating the anticipated investment operations of the fund and thus contravene the intent behind Form N1-A.[167] The generic disclosures vary from highly abbreviated to lengthy and technical disclosures. The problem is that they "may not enable investors to distinguish which, if any, derivatives are in fact encompassed in the principal investment strategies of the fund or specific risk exposures they will entail."[168] Because of that, the SEC expects all funds that use or intend to use derivative instruments to, among other things, (1) assess the accuracy and completeness of their disclosure, (2) explain the importance of the use of derivatives in their investment strategies, and (3) describe the purpose that the derivatives are intended to serve in the portfolio (such as hedging, speculation, or as a substitute for investing in conventional securities) and the extent to which derivatives are expected to be used.[169]

Before the enactment of the Dodd-Frank Act, there was some ambiguity whether equity swaps and other derivatives are "Investment Securities" and therefore must be disclosed, as the Investment Company Act borrows the definition of "security" in Securities Act § 2(a)(1), which at the time excludes "security-based swap agreements."[170] The Dodd-Frank Act now amends Section 3(a)(10) of the Exchange Act and Section 2(a)(1) of the Securities Act to include "security-based swaps" within the listing of items that are defined as securities. Accordingly, security-based swaps should also be deemed "securities" for purposes of the Investment Company Act.

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[166] Hu & Black, *supra* note 15, at 875.
[167] *See* SEC Letter to Investment Company Institute (July 30, 2010), *available at* http://www.sec.gov/divisions/investment/guidance/ici073010.pdf
[168] *Id.*
[169] *Id.*
[170] Before Dodd-Frank, some courts had interpreted "securities" under the Investment Company Act to mirror that of the Securities Act and excluded equity swaps from this definition. *See e.g.,* SEC v. Nat'l Presto Indus., Inc. 486 F. 3d 305, 309-10 (7th Cir. 2007). *See also,* Investment Company Act § 2(a)(36); 15 U.S.C. § 80a-3(a)(2) (2000).

Investment Company Act § 17(f), 15 U.S.C.A. § 80a-17; Form N1-A, 17 C.F.R. § 274.11A.

Hu & Black state that there is no statutory requirement to disclose specific share lending or non-short-sale-related borrowing positions.[171] The SEC has nonetheless encouraged mutual funds to recall and vote loaned shares. Under Section 17(f) of the Investment Company Act, a mutual fund must keep its shares and other assets in the custody of a bank or another specified entity. The SEC has taken the position that mutual funds may violate Section 17(f) if they lend at any given time securities representing more than one-third of their assets.[172] The SEC has also stated in a no-action letter that "[w]e would not object if voting rights pass with the lending of securities."[173] However, this does not relieve the directors of a fund of their fiduciary obligation to vote proxies. If the fund management has knowledge that a material event will occur affecting an investment on loan, the directors would be obligated to call such loan in time to vote the proxies.[174] SEC rules do require mutual funds and investment advisers to disclose how they vote (if they choose to), but they are silent on lending.[175]

D. The Dodd-Frank Act

Enacted in July 2010, The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act")[176] creates a comprehensive framework for regulating over-the-counter (OTC) derivatives as well as swap dealers and certain other designated participants in the derivatives markets. This legislation confers jurisdiction on both the SEC and the CFTC, based on the whether the underlying derivative is defined as a securities-based swap. The CFTC's jurisdiction is based on a broad definition of swaps. The SEC's jurisdiction, on the other hand, is confined to security-based swaps, which are generally swaps based on a single security or loan or referencing a single issuer or issuers in a narrow-based index. Much of the scope and impact of the Dodd-Frank Act will depend on regulations the CFTC and SEC are directed to create within 360 days of its enactment.[177] A precise assessment of the

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[171] Henry T. C. Hu, Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. Cal. L. Rev. 811, 875 (2006).
[172] The Brinson Funds et al. SEC No-Action Letter, 1997 SEC No-Act. LEXIS 1024 (Nov. 25, 1997).
[173] *Id.*
[174] State Street Bank & Trust Co., SEC No-Action Letter, 1972 SEC No-Act. LEXIS 4607 (Sept. 29, 1972).
[175] Final Rule, Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Investment Company Act Release No. 33-8188, 2003 WL 215451 (Jan. 31, 2003).
[176] The Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[177] Reform of the Swaps Market under Dodd-Frank Act, *available at* http://www.cravath.com/files/Uploads/Documents/Publications/Dodd-Frank%20(Reform%20of%20the%20Swaps%20Market).pdf (Sept. 20, 2010).

implications of the Dodd-Frank Act for the derivatives market is therefore currently impractical.

Prior to the enactment of Dodd-Frank, derivatives-trading was split into a regulated sector involving standardized contacts, such as options and certain exchange-traded futures, and the unregulated over-the-counter market. Products traded in this unregulated market include commodity swaps, interest swaps, equity swaps, credit default swaps, and commodity swaps. Derivatives in this market are bilateral contracts individually negotiated between the customer and dealer, and are also described as over-the-counter transactions. Unlike the case of exchange traded derivatives, there is no currently central reporting of prices or trades and parties must seek dealer quotes to get price data.

Title VII of the Dodd-Frank Act, titled "Wall Street Transparency and Accountability Act of 2010" ("Title VII"), promises to radically alter the derivatives market by, among other things, providing for the standardization, clearing and exchange trading of certain swap contracts previously traded over-the-counter.[178] The CFTC and SEC are directed to adopt rules mandating that swaps traded on exchanges or swap execution facilities be reported in real-time. All swaps must be reported to a registered swap data repository, and data reported must include information describing the price and volume. However, the Act exempts certain derivative contracts from the clearing requirements if one or more of the counterparties: (1) is not a financial entity; (2) is using swaps to hedge or mitigate commercial risk; and (3) notifies the regulators (in a prescribed manner) of how it generally meets its financial obligations associated with the non-cleared swaps.[179]

In addition, Title VII of the Act amends Sections 13 and 16 of Exchange Act to establish that, with respect to an equity swap, persons will be deemed to have acquired beneficial ownership of an equity security only if the SEC determines that (i) such swap transaction "provides incidents of ownership comparable to direct ownership of the equity security" and (ii) such determination is necessary to achieve the purposes of the Title VII.[180] Title VII also amends Sections 13(d)(1), 13(f)(1) and 13(g)(1) of the Exchange Act to require reporting of beneficial ownership positions created by security-

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[178] *Id.*
[179] *Id.*
[180] Title VII provides that a "security-based swap" includes any swap that is based on (i) a narrow-based security index, (ii) a single security or loan, or (iii) the occurrence, non-occurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers in a narrow-based security index (provided that such event must directly affect the financial statements, financial condition or financial obligations of the issuer). The term "security-based swap" excludes any agreement, contract or transaction that meets the definition of a security-based swap only because such agreement, contract or transaction references, is based upon, or settles through the transfer, delivery or receipt of an exempted security unless such agreement, contract or transaction is of the character of, or is commonly known in the trade as, a put, call or other option. *See* The Wall Street Reform and Consumer Protection Act of 2010, *supra* note 176.

based swaps to the extent consistent with the SEC rules.[181] In addition, a new subsection 13(o) of the Exchange Act provides — for purposes of Section 13 and Section 16, relating to disclosure and short-swing profit recovery for directors, officers and beneficial owners of more than 10% — that beneficial ownership of the security underlying a security-based swap may be deemed to have been acquired if the SEC determines that the security-based swap provides incidents of ownership comparable to direct ownership and that doing so is necessary to achieve the purposes of Section 13 of the Exchange Act.

Accordingly, SEC rulemaking again appears to be central with regard to the regulation of disclosures relating to transactions that separate the economic and voting interests of the underlying securities.

E. The SEC's Final Rule Providing for Shareholder Director Nominations ("Proxy Access") and Concept Release On The U.S. Proxy System ("Proxy Plumbing Release")

On August 25, 2010, the SEC issued final rules to facilitate "the effective exercise of shareholders' traditional state law rights to nominate and elect directors to company boards of directors."[182] These rules will require, under certain circumstances, that a company's proxy materials to provide shareholders with information about, and the ability to vote for, a shareholder's, or group of shareholders', nominees for director. The rules make proxy access available to shareholders that hold 3% or more of the company's voting shares[183] for a period of at least 3 years as of the date of the filing of the proposal.[184]

The rules require that the proponent have both the power to vote (defined as the power to direct the voting) and the investment power (defined as the power to dispose of, or direct the disposal of) the securities at issue.[185] The rules also address issues surrounding securities lending and short selling. The proxy access rules do not, however, address other transactions that can be used to decouple economic interests from formal voting rights. As such, the final rules leave open the potential for a institutional investor with a greater than 3% ownership stake in a company to get a director candidate onto the company's proxy even if that investor has less than a 3% economic stake (or no economic stake, or indeed a negative economic stake) in the subject company.

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[181] Reform of the Swaps Market under Dodd-Frank Act, *available at* http://www.cravath.com/files/Uploads/Documents/Publications/Dodd-Frank%20(Reform%20of%20the%20Swaps%20Market).pdf (Sept. 20, 2010).
[182] SEC Release Nos. 33-91136 (Aug. 25, 2010), *available at* www.sec.gov/rules/final/2010/33-9136.pdf; 34-62764; IC-29384; File No. S7-10-09.
[183] 17 C.F.R. § 240.14a-11(b)(1).
[184] 17 C.F.R. § 240.14a-11(b)(2).
[185] *See* instruction 3.c. to Rule 14a-11(b)(1).

While the SEC has left this door open, it may revisit the issue as part of an ongoing, years-long reevaluation of the U.S. proxy voting system. The Commission issued a "Concept Release on the U.S. Proxy System" on July 14, 2010,[186] which provides a comprehensive review of and solicits for public comments about multiple aspects of the current proxy voting system. Among the topics addressed is an examination of "empty voting and related decoupling issues."[187] Following the receipt by the SEC of comments in this area, if the SEC determines to require disclosure of decoupling transactions and related techniques, or more aggressively seeks to restrict voting by empty or negative shareholders, then the SEC may determine to apply the same rules to shareholder proxy access.

V. DEBT DECOUPLING AND EMPTY VOTING UNDER FEDERAL BANKRUPTCY LAWS

This section addresses the issue of decoupling in debt markets, and implications for the bankruptcy process. This section provides an overview of the Chapter 11 reorganization process, identifies areas in that process where empty creditors could act in a manner contrary to the purpose and intent of the bankruptcy statutes, and summarizes potential solutions to these issues that have been suggested by commentators.

A. Overview of the Chapter 11 Reorganization Process

As Beck describes, "Chapter 11 of the Bankruptcy Code (the Code) provides a financially troubled business the opportunity to catch its financial breath, propose a plan to reorganize and to thereby allow it an opportunity to cure its financial ills and continue its business."[188] The goal is the creation, distribution and confirmation of a reorganization plan that determines when and how debtors will be repaid while allowing the business the opportunity to continue.[189]

Commencing with the filing of either a voluntary petition for bankruptcy by the debtor or by an involuntary petition by a creditor,[190] the bankruptcy process leaves the management of the business in charge of conducting its affairs as a "debtor in possession," a fiduciary charged with all of the duties of a bankruptcy trustee save for investigator responsibilities. These duties include accounting for property, examining

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[186] SEC Release Nos. 34-62495; 1A-3052; IC-29340; File No. S7-14-10), *available at* www.sec.gov/rules/concept/2010/34-62495.pdf (announcing an effort to promote greater efficiency and transparency in the U.S. proxy system and enhance the accuracy and integrity of the shareholder vote).
[187] *Id.* at 137-150.
[188] Beck, *supra* note 129, at 1279, citing *In re Continental Airlines Corp.*, 38 B.R. 67, 71 ((Bankr. S.D. Tex. 1984).
[189] *Id.*
[190] 11 U.S.C. §§ 301, 303.

and objecting to claims, and filing monthly operating reports with the Court.[191] The U.S. Trustee appoints a creditors' committee that typically consists of the unsecured creditors that hold the seven largest claims against the debtor.[192] This committee is required to act "in the interest of those represented" and work with the debtor in possession in the administration of the bankruptcy case, investigate the debtor's conduct and operation of the business, and participate in the formulation of a reorganization plan.[193] Committee members are fiduciaries subject to duties of loyalty and care.[194]

Notwithstanding the official committee structure, all creditors are "parties in interest" with the right to raise any issue in a case and to "appear and be heard on any issue in a case."[195] As observed by James Shea in his 2008 article, similarly situated creditors that are not satisfied with the official committee or its processes often band together and form "ad hoc" groups to appear in Chapter 11 cases. [196] These ad hoc "groups" or "committees" frequently consist of hedge funds and/or other institutional investors that buy and sell distressed debt.[197]

Once a reorganization plan is developed, Beck observes that the plan's proponent "must obtain the acceptance of the plan by each class of claims," and describes the voting process as follows:

> "Section 1126 provides the framework for the voting process by identifying which creditors may vote and the number and amount of votes needed for acceptance by a class. The focus of §1126 is on creditor democracy and 'rests on whether the class as a whole votes for or against the plan.' For a class of creditors to accept a proposed plan, the Code requires (1) the approval of two-thirds in amount and (2) a majority in number of the claims in each class of creditors. The supermajority requirement protects the large creditors while the numerosity requirement provides small creditors some protection because otherwise the large claims would dilute the voting power of the small creditors. Claims not voted or that are disallowed—because they have been designated as bad faith—do not enter into the calculation. Indeed, even if only one member of a class votes to accept a plan, but all other members decline or are not able to vote, the entire class will have accepted the plan."[198]

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[191] 11 U.S.C. §§ 1106, 1107; Fed. R. Bankr. P. 2015(a).
[192] 11 U.S.C. §1102.
[193] 11 U.S.C. §1103.
[194] James M. Shea, Jr., *Who is at the Table? Interpreting Disclosure Requirements for Ad Hoc Groups of Institutional Investors Under Federal Rule of Bankruptcy 2019*, 76 Fordham L. Rev. 2561, 2584 (2008).
[195] *Id.* at 2585 (citing 11 U.S.C. §1109(b) and *In re Adelphia,* 359 B.R. 54, 64 (Bankr. S.D.N.Y. 2006)).
[196] *Id.*
[197] *Id.* at 2586.
[198] Beck, *supra* note 129, at 1281-1282 (citing David A. Skeel, Jr.'s scholarship and several other authorities).

The practical effect of these rules is that a creditor can block a restructuring plan if the creditor holds one-half in number, or one-third in amount, of the claims of a particular class of creditors.[199]

B. Potential Areas for Abuse of Reorganization Process By Empty Creditors

Empty creditors might seek to influence the Chapter 11 process to serve their own ends rather than those of the creditors at large, at four distinct stages of the process:

- At the time of filing the petition, if an involuntary petition filed by an empty creditor;
- An empty creditor participating on an official creditors committee;
- An empty creditor participating in an ad hoc committee; and
- An empty creditor casting a self-interested vote on a reorganization plan based on its hedging position.

We will discuss each in turn.

1. Involuntary Petition Filed by Empty Creditor

Hu and Black have identified the possibility that an empty or negative creditor may be incentivized to reduce the value of all debt claims and "might prefer that the company fail, and hence oppose an out of court restructuring," resulting in a bankruptcy filing.[200] Although they made this observation in reference to a creditor's potential reluctance to engage constructively in negotiations over an out-of-court resolution, which is beyond the scope of this paper, the potential exists that an empty or negative creditor that would profit from a negative credit event such as bankruptcy might attempt to file an involuntary bankruptcy petition against the debtor and force such a result. Section 303 provisions that authorize bankruptcy judges to order that economic and punitive damages be paid by a petitioner who files a petition in bad faith, [201] coupled with the ability to require the petitioner to file a bond indemnifying the debtor for such amounts as the court may later allow,[202] might deter such strategies, but only if bankruptcy court judges make appropriate inquiries and act on information suggesting the participation of empty creditors.

2. Participation on Official Creditor's Committee

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[199] Daniel Hemel, *Empty Creditors and Debt Exchanges*, 27 Yale J. on Reg. 159, 164-165 (2010) (citing 11 U.S.C. § 1126 (c)).
[200] Hu & Black, *supra* note 115, at 682.
[201] 11 U.S.C. § 303(i)(2).
[202] 11 U.S.C. § 303(e).

As noted above, members of an official creditors committee are obligated to represent the interests of all creditors that they represent, and are subject to the fiduciary duties of loyalty and care.[203] However, as Sandler and Coniglio point out, without knowledge that an unsecured creditor has hedged its claim the U.S. Trustee may select an empty creditor to be a member of the committee "even though such a creditor's exposure is significantly less than the other secured creditors and even though such a creditor may wish a different, if not contrary, result from the other secured creditors."[204] Consideration might be given to amending 11 U.S.C. §1102 to require a creditor to disclose any hedging positions before their appointment to a creditors committee.

3. Participating in Ad Hoc Committees

At present, disclosure of hedging positions is not specifically required by members of ad hoc committees advocating for outcomes that may be designed to benefit the members because of their hedging positions rather than because of a benefit to creditors generally. Federal Bankruptcy Rule 2019 sets forth a number of disclosure requirements applicable to ad hoc committees, but does not specifically require the disclosure of hedging positions.[205] Commentators have also observed that ad hoc committee filings often do not fully disclose the information required by the current rule.[206]

Proposed amendments to Rule 2019 have been submitted and are pending final adoption that would "reinvigorate" the disclosure requirements to ensure compliance. They would specifically address the disclosure of hedging positions by adding a definition of "disclosable economic interest" that reads:

> "Disclosable economic interest" means any claim, interest, pledge, lien, option, derivative instrument or any other right or derivative right granting the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest."[207]

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[203] *See* text accompanying note 173, *supra.*
[204] Sandler and Coniglio, *supra* note 121, at *4.
[205] U.S.C.S. Bank. R. 2019.
[206] Shea, *supra* note 173, at 2595. *See, e.g.*, Letter from Judge Robert E. Gerber to Advisory Committee on Bankruptcy Rules (Jan. 9, 2009) (recommending amendments to Rule 2019 that broaden its disclosure requirements).
[207] *See, e.g.,* Memorandum to Committee on Rules of Practice and Procedure from Advisory Committee on Bankruptcy Rules, May 27, 2010 (revised June 14, 2010) (discussing Proposed Federal Bankruptcy Rule 2019(a)(1)).

4. Voting on Reorganization Plan

The issues raised by empty creditors voting on a reorganization plan, and the potential for the creditor's vote to be motivated by interests other than the best interests of the creditors generally was raised in a motion in the *Adelphia* bankruptcy.[208] Section IV-B below discusses the implication of this case and a recent decision by the Bankruptcy Court relevant to the empty voting issue.[209]

C. Addressing Potential Abuses by Empty Creditors in Voting on Reorganization Plans

As Beck observed, the ultimate weapon in a bankruptcy judge's arsenal to address abuses by empty or negative creditors in a Chapter 11 proceeding is the ability to "designate" or disqualify the votes of the creditor pursuant to 11 U.S.C. § 1126 (e). However, as the judge in *Adelphia* noted in deciding motions for designation:

> "The ability to vote on a reorganization plan is one of the most sacred entitlements that a creditor has in a Chapter 11 case. And in my view, it should not be denied except for highly egregious conduct—principally, seeking to advance interests apart from recovery under the Plan, or seeking to extract plan treatment that is not available for others in the same class."[210]

While, as noted above, the same judge expressed a willingness to disqualify the votes of an empty/negative creditor upon a showing that the votes would be adverse to other creditors, the severity of the designation sanction suggests that other solutions to the problem should also be considered. Beck, for example, suggests as potential options: (1) Creating a separate class for empty creditors; (2) Using claims under contract law in a manner that would result in the noncreditor counterparty to the TRS to police potential creditor abuses; (3) Allowing the noncreditor counterparty to the TRS to vote the claim because its interests are more aligned with the non-hedged creditors; and (4) Doing nothing unless the creditor sells enough bonds post-petition to convert the TRS into a naked swap but maintains enough claims to control the reorganization process.[211]

Other solutions have also been proposed. Kevin Coco suggests that disclosure rules should be enhanced when a creditor has a stake large enough to block a reorganization plan.[212] In addition to disclosure of hedging positions in bankruptcy, Hu and Black suggest that in the future voting rights in bankruptcy "may need to be based on net economic ownership instead of gross ownership of debt."[213] Hemel suggests that

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[208] *In re DBSD North America, Inc.*, 421 B.R. 133, 143, fn. 44 (Bankr. S.D.N.Y. 2009).
[209] *Id.*
[210] *In re Adelphia Communications Corp.*, 359 B.R. 54, 56-57 (Bankr. S.D.N.Y. 2006).
[211] *See* text accompanying note 129, *supra.*
[212] Kevin J. Coco, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 Colum. Bus. L. Rev. 610, 650 (2008).
[213] Hu & Black, Decoupling II at 735.

instead of focusing on the empty creditor and/or the bankruptcy process, consideration be given to modifications to the terms of swap agreements by protection sellers to shield themselves from an empty creditor seeking to destroy value, thereby in turn providing a disincentive for the empty creditor to act contrary to the interests of other debtors and the bankruptcy estate as a whole.[214]

VI. DEBT AND EQUITY DECOUPLING IN SELECTED JUDICIAL DECISIONS

The body of judicial decisions examining the problems associated with economic and voting rights decoupling is thin, because the litigated history of the phenomenon is short. Less than thirty years ago, the legal community considered it "not possible to separate the voting right from the equity interest."[215] Perfect alignment of interests was assumed on the notion that someone who wanted to buy a stock vote must, too, buy a share. But with the exponential growth of financial instruments, in terms of both popularity and creativity, the issue of empty voting emerged and began to make its way into the courtroom in this past decade.

Our review of the relevant literature in Section I above includes a broad overview of cases such as *Perry v. Mylan*[216] and *Schreiber v. Carney.*[217] In this Part IV, we examine four seminal cases and highlight some considerations that the courts have deemed important in addressing empty voting issues.

A. *Crown EMAK* and Vote Buying in Delaware

In Delaware, the courts have long expressed concerns about transactions that create a misalignment between voting and economic interests. Earlier this year, the Delaware Supreme Court revisited the importance of those public policy concerns in *Crown EMAK Partners LLC v. Kurz.*[218] The litigation involved two competing factions seeking control of the board of directors of EMAK Worldwide, Inc. ("EMAK"). To secure its majority, the insurgent group ("TBE") paid fair value to purchase the voting and economic rights of certain EMAK shares from Peter Boutros ("Boutros"), a former EMAK employee.[219] Although Boutros's restricted stock grant prohibited transfer of the shares prior to March 2011, the parties entered into a purchase agreement that delayed the actual transfer of title until after the expiration of the transfer restriction, but it otherwise provided for an immediately effective proxy to vote the shares, along with other economic rights and

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[214] Hemel, *supra* note 182, at 169-170.
[215] Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & Econ. 395, 410 (1983).
[216] *See* Parts III-A-3 and III-B-1, *supra*.
[217] *See* Part III-A-10, *supra*.
[218] 992 A.2d 377 (Del. 2010).
[219] *Id.* at 383-385.

entitlements.[220] In effect, Boutros transferred to the purchaser full ownership of the shares, with bare legal title to be formally assigned to the purchaser upon the expiration of the restriction period.

On the legality of this transaction, the Delaware Supreme Court affirmed the Chancery Court's decision that (1) as a general matter, third-party vote buying merits judicial scrutiny when it disenfranchises shareholders by affecting the outcome of a vote, such as in this case, (2) the transaction at issue was not an impermissible vote buying transaction, but (3) the transaction violated the term of the restrictive stock grant.[221] The Court explained that where voting rights accompany the economic risks of ownership, a sale transaction constitutes permissible vote buying in the absence of fraud.[222] In fact, possessing both economic risk and voting interests of a stock gives rise to full ownership, even when the owner has yet to receive formal legal title to the stock.[223] On the other hand, buying votes without also assuming economic risks may have an impermissible, deleterious effect because a shareholder who divorces property interest from voting interest would "fail to serve the community of interest among all shareholders."[224] Where a decoupling of voting and economic interests occurs, the Court noted, the vote may not reflect the "rational, economic self-interest" arguably common to all shareholders.[225]

The public policies examined in *Crown EMAK* justify the suspicion with which Delaware courts scrutinize vote buying deals that do not come with full economic interests. *Crown EMAK* takes a special role in the empty voting debate because the Delaware Supreme Court often "has the last word in corporate jurisprudence."[226]

B. ***CSX Corp.* and the Definition of "Beneficial Ownership" Under Federal Securities Law**

CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP[227] addresses the question of whether an investor can avoid federal reporting obligations through the use of total return equity swaps. The court and the SEC, as further explained below, did not reach the same conclusion on this question.

To appreciate the context of *CSX Corp.*, it is necessary to understand the mechanics of a total return swap ("TRS"). An equity swap agreement provides for the swapping of

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[220] *Id.*
[221] *Id.* at 388-389.
[222] *Id.* at 387-388.
[223] *Id.*
[224] *Id.* at 388 (quotations omitted).
[225] *Id.*
[226] Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corpo-rate Law and Governance from 1992- 2004? A Retrospective on Some Key Developments*, 153 U. Pa. L. Rev. 1399, 1408 (2005)
[227] 562 F. Supp. 2d 511 (S.D.N.Y. 2008).

different cash flows between a long party and a short party over a fixed period without requiring any exchange of the underlying reference assets. In a simple TRS, the short counterparty pays the long counterparty money upon a positive performance of the reference securities. The long counterparty in turn must pay the short party a periodic interest amount based on a negotiated principal amount plus a payment to cover any market depreciation of the referenced securities. This arrangement allows the long counterparty to benefit from the underlying asset's performance without expending high capital outlays to acquire the asset and owning legal title to the asset.[228]

The litigation in *CSX* stemmed from a proxy contest between CSX Corp. ("CSX") and TCI and 3G, two activist hedge funds dissatisfied with CSX's performance and management.[229] TCI invested in CSX stock by entering into TRSs that referenced approximately 14% of all CSX shares with a number of investment banks acting as short counterparties.[230] TCI employed TRS arrangements, as opposed to a direct stock purchase, in an effort to avoid SEC reporting requirements by spreading its swap transactions among eight counterparties so as to avoid anyone hitting the 5% threshold that would trigger reporting obligations under Section 13(d) of the Exchange Act. After TCI failed to convince the company's management to adopt its reform proposal, it joined force with 3G (together with TCI, the "Group") to launch a proxy contest in early 2008 in an effort to replace a number of directors with their own candidates.[231] CSX filed a complaint against the Group in March 2008 alleging, among other matters, that the Group failed to make timely disclosure of TCI's threshold holding and of the Group's formation.[232]

The District Court decision focused on two main issues: (1) whether the TRSs did, in fact, confer "beneficial ownership"[233] upon TCI and, if so, (2) whether the Group could delay filing a Schedule 13D by merely disclaiming their existence as a group.

Examining the definition of "beneficial ownership" under SEC Rule 13d-3(a), the Court made a number of important factual observations that *could have* supported a conclusion that TCI was the beneficial owner of the CSX shares held by its short counterparties. First, the TRS contracts at issue did not grant TCI any legal rights with respect to the voting or disposition of the shares referenced by the swaps, nor did they require the banks to hedge their positions by purchasing CSX shares.[234] Yet, the Court

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[228] *See generally*, *id.* at 520-523.
[229] *Id.* at 524.
[230] *Id.* at 526.
[231] *Id.* at 535-536
[232] *Id.* at 538.
[233] "Beneficial ownership" is separately defined under SEC Rule 13d-3(a) 23 and Rule 13d-3(b). Rule 13d-3(a) 23 provides that any person who obtains either voting power or investment power in a security is the beneficial owner of such security. Rule 13d-3(b) provides that if a person is found to have purposefully evaded the reporting requirements by entering into any arrangement with the express intention of preventing beneficial ownership from vesting, that person will be deemed the beneficial owner of the security.
[234] *CSX Corp.,* 562 F. Supp. 2d at 540.

found that TCI knew and expected that the short counterparties, as a practical matter, would buy and sell CSX shares to hedge their exposures on the very same day that TCI entered into or unwound a swap transaction.[235] Moreover, there was evidence that the relationship between TCI and certain banks was such that TCI could influence the banks' exercise of their voting rights.[236] Pointing to TCI's ability to control or influence the voting or disposition of the CSX shares held by its swap counterparties, the Court strongly hinted that a finding of "beneficial ownership" under Rule 13d-3(a) would be justified on the facts at hand. However, the SEC, weighing in as an *amicus curiae*, took a different view and sided with TCI's interpretations of "beneficial ownership" in this case.

In its *amicus* letter, the SEC Division of Corporate Finance argued that, as a legal principle without any factual assessment, there should be no beneficial ownership where the short counterparties buy, sell, or vote their hedge shares as a result of their own economic incentives and not pursuant to contractual obligations owed to their long counterparties.[237] The Court disagreed and criticized the SEC's focus on TCI's legal rights as "form over substance."[238] Scholarship in the field, Judge Kaplan noted, recognizes that "abuses would be facilitated by a regime that did not require disclosure of the sort that would be required if 'beneficial ownership' were construed as advocated by CSX."[239] Nonetheless, after dedicating a significant part of the opinion to the issue of "beneficial ownership," Judge Kaplan deemed it unnecessary to rule on the legal question of whether TCI was a beneficial owner under Rule 13d-3(a).[240] Instead, he held that because the Group had employed the TRSs as a vehicle to evade its reporting requirements under Rule 13d-3(b), it was deemed a beneficial owner of the shares held by its counterparties to hedge their exposures.[241]

The Court also resolved the second issue in favor of CSX, finding that TCI and 3G acted as a group well before these parties disclosed their group status in Schedule 13D.[242] Notwithstanding these findings, the Court did not enjoin the Group from voting its shares or proxies because the Group and its members' actions did not cause irreparable harm as a matter of law.[243]

The CSX decision has several important implications. First, while Judge Kaplan did not reach a conclusion regarding the alleged violation of Rule 13d-3(a), his analysis

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[235] *Id.* at 541-542.
[236] *Id.* at 543.
[237] *Id.* at 547.
[238] *Id.*
[239] *Id.* (referencing Professors Henry Hu and Bernard Black's empty-voting scholarship and citing an amicus letter from Professor Joseph Grundfest, who warned that nondisclosure in the context of this case would undermine the integrity of the stock market and create an uneven playing field).
[240] *Id.* at 548.
[241] *Id.* at 552.
[242] *Id.* at 554-555.
[243] *Id.* at 568-571.

provides a framework for a court to find that cash-settled equity swaps meet the definition of "beneficial ownership" under Rule 13d-3(a) because they confer on the long counterparty the power to influence both the voting and disposition of the underlying stock. Second, the SEC, when acting as a fact finder, may very well reach a different conclusion from a court on whether disclosure is required for economic interests owned through a swap arrangement.

Two years later, the *CSX* decision remains on appeal before the Second Circuit. The hedge funds and two prominent trade associations, filing as *amici curiae*, challenge the trial court's decision, arguing that (1) "beneficial ownership" requires actual voting or investment power, not mere influence, and (2) the court should defer to Congress or the SEC on whether to deem cash-settled swaps as conferring "beneficial ownership." CSX and a group of former SEC officials and prominent scholars, also filing as *amici curiae*, argue that swaps are not categorically excluded from Rule 13d-3(a) and that TCI's equity swaps in fact constituted a scheme to evade reporting requirements. Since then, the enactment of the Dodd-Frank Act has resolved at least one issue, making clear that certain security-based swaps may in fact be deemed to constitute "beneficial ownership" under Sections 13(d)(1) of the Exchange Act, subject to further rulemaking by the SEC.

Whatever the outcome of the CSX appeal may be, the *CSX* case has shined a spotlight on the question of securities-based swap disclosure and likely increased the pressure on the SEC to adopt new disclosure rules.[244] Combined with the Dodd-Frank Act's mandate for additional rulemaking,[245] we can expect that the SEC will explicitly address this issue in the near future.

C. ***Adelphia*, *DBSD*, and Creditor's Voting Rights In Chapter 11 Cases**

1. In re Adelphia

In *In re Adelphia Communications Corp.*,[246] the Bankruptcy Court weighed in on the consequences of economic and voting interest misalignment in a complex chapter 11 case. A group of creditors of Adelphia Communications Corporation and its subsidiaries (collectively, the "Debtors") filed a motion to disqualify the votes of three distressed debt investor creditors (the "Targeted Creditors") alleging, among other matters, that the Targeted Creditors held claims of multiple Debtors with conflicting interest.[247] The conflicting interest among the claims, as alleged, could result in the Targeted Creditors favoring a devaluation of a certain Debtor in favor of the recovery of another Debtor.[248]

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[244] *See* Hu & Black, *supra* note 115, at 669.
[245] *See* Part IV-D, *supra*.
[246] 359 B.R. 54 (Bankr. S.D.N.Y. 2006).
[247] *Id.* at 62.
[248] *Id.* at 64-65.

Under bankruptcy law, the right to vote for a reorganization plan "is one of the most sacred entitlements that a creditor has in a chapter 11 case . . . [and] should not be denied except for highly egregious conduct principally, seeking to advance interests apart from recovery under the plan."[249] Judge Robert Gerber explained that the conflict of interest arising from one creditor holding claims against multiple debtors, or claims against a single debtor in different classes, does not in and of itself represent an ulterior motive or highly egregious conduct warranting a disqualification of the creditor's vote under 11 U.S.C. §1126(e). "Ulterior motive" or "highly egregious conduct" typically requires some intent to assume control of a debtor, to put the debtor out of business, or to destroy the debtor out of malice to justify a Section 1126(e) sanction.[250] Even if the allegations were true and the Targeted Creditors were overly aggressive in acting to maximize their recoveries, the Court found no precedent to characterize the Target Creditors as acting with the degree of bad faith that would justify depriving them of their right to vote.[251]

The facts here paint a misalignment between creditors' voting rights and economic interests of in a convoluted bankruptcy matter, but there was no negative voting issue in this case. Despite owning some conflicting claims, the Targeted Creditors still sought to recover from their long debt positions under one reorganization plan. In part for that reason, the voting rights of the Targeted Creditors were not compromised.

2. In re DBSD

Three years later, Judge Gerber once again visited the problem of empty voting in *In re DBSD North America, Inc.*[252] This Chapter 11 proceeding involved a creditor who also had a substantial investment in a direct competitor of the debtors.[253] Unlike the outcome in *Adelphia*, here the Court disqualified the creditor's votes on the ground that it bought the debtors' debt with an intention to control the bankruptcy process and assume control of the debtors' strategic assets. Whereas the "disgraceful conduct" in *Adelphia* arose from an effort to maximize recoveries by creditors holding long positions in debt, the creditor in the *DBSD* case acted to advance strategic investment interests unrelated to any desire to recover on its long debt position.[254]

In *DBSD*, the Court reflected back on *Adelphia* and made two notable observations. First, there was a second disqualification motion in the Adelphia proceeding, directed at certain distressed debt investor creditors who allegedly held long debt positions on one debtor and short positions on another debtor.[255] There, evidence existed that the investor creditor opposed the settlement of an inter-debtor dispute because they would

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[249] *Id.* at 56.
[250] *Id.* at 63.
[251] *Id.* at 65.
[252] 421 B.R. 133 (Bankr. S.D.N.Y. 2009).
[253] *Id.* at 134-135.
[254] *Id.* at 141-142.
[255] *Id.* at 143.

earn a large profit from a distribution that would result in more losses being assigned to the debtor in which they held the short position. Judge Gerber noted in *DBSD* that if the second Adelphia motion had not been withdrawn and the evidence presented had not been refuted, he would have disqualified the votes of the Adelphia investor creditor "in a heartbeat."[256] His second reflection was that the *Adelphia* opinion "may actually encourage the sort of intractable conduct that the court found to be objectionable and unproductive, yet outside the scope of section 1126(e)."[257] Congress, he argued, must "modify the [Bankruptcy Code] to authorize Bankruptcy Judges to designate creditor votes for overly-aggressive and other egregious conduct even when the creditors are trying to increase returns on long positions." [258]

Adelphia and *DBSD* demonstrate that judges recognize the inequity of empty voting in bankruptcy cases, while also cognizant of the risk of excessive disenfranchisement of creditors who have a real stake in ensuring that a Chapter 11 case culminates successfully. In cases where an empty creditor has no economic interest in the overall success of the debtor, or has an ulterior motive to control the debtor's assets, it may very well lose its voting rights in a bankruptcy court. However, in cases where voting is not negative, but merely disproportionate to the creditor's net economic interest, *Adelphia* and *DBSD* suggest that the Bankruptcy Court may not be able to effectively address any resulting inequity. At least not until Congress either amends the Bankruptcy Code or expands the court's power to fashion equitable reliefs.

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[256] *Id.*
[257] *Id.*
[258] *Id.*

VII. CONCLUSION

This Report summarizes the state of the literature on the complex issues of decoupling transactions, empty voting, negative voting, and vote buying. This Report also summarizes major statutory provisions and regulations that may be affected by these developments, and examines the leading judicial opinions addressing these emerging concerns.

This Report takes no position on the social welfare implication of transactions that give rise to a decoupling of voting rights from the corresponding financial exposure, or to the exercise of such voting rights. Rather, the Report suggests that the challenges posed by these transactions can be real and profound. They can threaten core presumptions on which corporate governance and bankruptcy proceedings rely and thus, deserve careful attention from regulators, legislators, and the judiciary.