THE ONE-SHARE-ONE-VOTE CONTROVERSY IN THE EU

Arman Khachaturyan*

* I would like to thank Joe McCahery, Roberta Romano, Karel Lannoo and Bernard Black for insightful comments and recommendations. E-mail: arman@ceps.be; arman.khachaturyan1@armentel.com

Abstract

The EC's proposal to establish shareholder democracy and mandate the one-share-one-vote rule (hereinafter referred to as 1S1V) has drawn much attention and controversy. In the pursuit of a popular appeal for the rule, EC policy-makers have tried to make equiproportional representation nearly an aphorism tied with corporate egalitarian sentiments underscoring justice, fairness and ethics.

Against this background, the question of "who could be against or oppose shareholder democracy and the 1S1V" has both positive and normative implications. Based on law, finance and economics literature, this article evaluates economic underpinnings and efficiency of the 1S1V and concludes that it is generally a suboptimal corporate voting mechanism compromising economic efficiency and distorting incentives of corporate constituencies. Moreover, it is submitted that any attempt to mandate the 1S1V in the EU may induce companies to move either to pyramidal structures, or worse yet, to use complex derivative instruments to decompose the 1S1V. While pyramidal holdings may further facilitate expropriation of private benefits of control as compared to the status-quo, the decomposition of the 1S1V can i) further advance heterogeneity of preferences of shareholders, ii) create incentives for negative voting arbitrage, iii) encourage the approval of value-reducing transactions or worse yet, become a takeover defense. Hence, even if the EC can hypothetically move corporate Europe from controlled ownership structures to minority ownership ones, the 1S1V is clearly worse than the status quo, and, paradoxically, instead of advancing rights of "disadvantaged shareholders", the 1S1V can further demote shareholder rights in the EU. As a result, the 1S1V can not promote a value enhancing corporate governance regime in the EU in general, and meet the policy objectives of the intervention in particular in terms of strengthening rights of shareholders, enhancing third party protection and fostering efficiency and competitiveness of businesses in the EU.

On the normative side, the issue is how corporate law can efficiently police the ability of controlling shareholders to expropriate minority shareholders in general and the ability to take private benefits in particular. Generally, it is submitted that if a corporate law regime is adequately structured, there would be less need to worry about the voting rule, and non-proportionate votes would not be a serious concern. This article concludes in this light by outlining some policy alternatives. First, it is proposed that EC policy-makers refrain from taking any measure at the level of the community, and, instead strengthen disclosure rules and enforcement thereof. Furthermore, some standards of review governing significant conflict of interest transactions can be introduced. Second, it is submitted that EC policy-makers can also provide for opt-in and opt out-provisions for the Member States. Such menus should be once again complemented by rigorous disclosure rules and enforcement thereof.

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INTRODUCTION

For a few years now, EC policy-makers have been trying to establish new democracy in the EU namely corporate democracy. As a result, corporate Europe has been long overdosed by a hefty dose of inconsistency stemming from the EC's Communication on Modernising Company Law and Enhancing Corporate Governance in the EU launched in 2003.[1] The Communication, as the argument goes, pursues three key policy objectives i.e. i) to strengthen the rights of shareholders, ii) to enhance third parties protection and iii) to foster efficiency and competitiveness of business.[2]

Critics of the EU corporate governance reform agenda have questioned whether the reform agenda and policy measures as proposed can create a value-enhancing corporate governance regime in the EU. Particularly, establishing shareholder democracy and enforcing the 1S1V across the board in the EU have been one of the most controversial proposals in the EC's reform agenda. Whereas political marketability of shareholder democracy and the 1S1V system has dominated the agenda of EC policy-makers, economic justification thereof as a value-enhancing corporate governance technique in terms of fostering efficiency and competitiveness has been stunningly absent from the agenda.

The conclusion this article draws from a wider finance, economics and law scholarship is that the 1S1V is simply a corporate decision rule among many others, and not necessarily the best one. The optimality conditions thereof are highly contestable, and, depending on circumstances and nature of corporate actions, the 1S1V can be value-decreasing. Moreover, the 1S1V can lead to changes both into organizational

[1] See Communication from the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward, Brussels, 21.5.2003 COM (2003) 284.

[2] See *Id.*

engineering and applications of different derivative techniques capable of further disenfranchising minority shareholders in the EU. And, hence, tying the 1S1V to shareholder democracy in the pursuit of protection of minority shareholders is both misperceived and misguided.

The rest of this article is organized as follows. Part A briefly reviews the concept and evolution of shareholder democracy in the comparative paradigm of the US and EU debates. Part B presents a brief overview of the economics of corporate voting. Part C examines the optimality of the 1S1V in the context of complete contracting, incomplete contracting, takeovers, ownership pyramids and derivative instruments. It also discusses justification and empirical support for the 1S1V as a preferred vehicle of shareholder democracy in the EU. This article concludes with summary remarks outlining key priorities and principles for revamping shareholder empowerment in the EU.

A. SHAREHOLDER DEMOCRACY

Proponents of shareholder democracy in the EU have been long inspired by the principles of political democracy. Political democracy both conceptually and procedurally has evolved around two fundamental dimensions. Conceptually, the substantive conception of democracy stipulates that an electoral system should be devised in such a way that the principles of democratic faith, fairness, objectivity and moral are met. Procedurally, the conception of democracy, as incorporating articles of conceptual substance, should provide for meaningful and non-discriminatory participation of the electorate in political processes through a right to vote. The one-person-one-vote principle and majority rule have emerged in the context of electoral systems in political democracies as embodying substantive and procedural dimensions of democracy.[3]

The recent corporate fallouts across the both sides of the Atlantic prompted unprecedented regulatory response aimed at the protection of shareholder rights, reducing fraud and increasing financial transparency and public confidence in the markets, as the argument goes. In an attempt to mitigate negative consequences of corporate fallouts, policy-makers have attempted to imitate the substantive and procedural conceptions of political democracy in corporate life and to a certain degree have succeeded doing so. This section briefly sketches the concept of corporate/shareholder democracy as it emerged and evolved in the US and the EU both conceptually and procedurally.

Shareholder Democracy in the US

Shareholder democracy in the US has been traditionally associated with shareholder representation and empowerment aimed at boosting shareholder activism and managerial accountability. The concept of shareholder democracy in the US has

[3] For the origin of the one-person-one-vote principle in the US, see e.g. *Gray vs. Sanders US 368, 381 (1963)* in which Justice Douglas argues that "The conception of political equality from the Declaration of Independence, to Lincoln's Gettysburg Address, to the Fifteenth, Seventeenth Amendments can mean only one thing – one person, one vote." See also Elstner J. (1998), *Constitutionalism and Democracy;* arguing that "[political democracy is a] simple majority rule, based on the principle, "One person one vote."

See also Issacharoff, S. and A., Lichtman (1993), "The Census Undercount and Minority Representation: The Constitutional Obligation of the States to Guarantee Equal Representation", *Review of Litigation* 13, 1; arguing that the one-person-one-vote principle is a fair, objective and easy standard of review to measure and remedy for any deviation from equiproportional representation in the political system.

been shaped by the Supreme Court of Delaware which intermediated two seminal standards of review namely *the Blasius Standard* and *the Unocal Standard*. Under the Blasius Standard the Court submitted that "the shareholder franchise is the ideological underpinning upon which the legitimacy of the directorial power rests."[4] Under the Unocal Standard, the Court redefined the fiduciary duties of board members in the context of hostile takeovers by recognizing that "because of the omnipresent specter that a board may be acting primarily in its own interest's, rather than those of the corporation and its shareholders…", a board of directors may attempt to thwart a takeover bid for self-interested reasons in order to protect or entrench themselves instead of fairly assessing pros and cons of a bid.[5] Hence, a board's response should be "reasonable" and "proportionate," and any defensive measure taken should be necessarily in the best interests of the company's shareholders.[6] Consequently, to the extent that a board's response is disproportionate to the threat posed, and defensive measures taken create a "preclusive or coercive" effect upon shareholders, shareholder should decide whether the board can effectively continue exercising its fiduciary duties.[7] Hence, in the context of hostile takeovers, shareholder democracy in the US becomes tantamount to the ability of shareholders to replace the board.

More recently the concept of shareholder democracy in the US has witnessed dramatic changes and proposals both in terms of shareholder approvals, nominations, voting criteria and corporate actions. The US Securities and Exchange Commission (SEC) e.g. has proposed a new director nomination rule aimed at making it i) less expensive and less cumbersome for shareholders to nominate board candidates and ii)

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[4] See *Blasius Industries vs. Atlas Corp*, 564, A.2d 651, 659 (Delaware 1988).

[5] See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

[6] See *Id.*

[7] See *Id.*

making boards more responsive and accountable.[8] This rule, if final, will allow shareholders under some qualifying circumstances, to nominate directors and have their nominees listed in the company's proxy materials after a "triggering event" as compared to the current situation allowing shareholders to nominate board candidates through incurring the costs of printing and distributing their own proxy materials.

The next important ramification of the recent corporate governance debate in the US in terms of shareholder democracy has been emergent calls to move from a pluralistic vote to a majority vote.[9] Some argued that corporate charters should mandate a majority vote for directorial elections, while the others like institutional investors have proposed that a majority vote should be mandatory for all aspects of corporate life.[10]

Against this background, while some scholars have stunningly advocated for more corporate democracy in terms of shareholders being able to initiate and vote on the company's basic corporate governance arrangements and "housekeeping rules of corporate law,"[11] others have posited fundamental concerns and disappointment as to whether more shareholder empowerment is the right way to reform corporate and securities laws in the US.[12]

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[8] See Proposed Rule 14a-11: Security Holder Director Nominations, Exchange Act Release Nos. 34-48626; IC-26206; File No. S7-19-03 (October 14, 2003) (Proposing Release). See also Press Release 2003-133 (Oct. 8, 2003).

[9] See "Should Directors Be Nervous", *The Business Week*, March 06, 2006. See also www.sers.state.pa.us/sers/cwp/view.asp?A=303&Q=264407

[10] See *Id.*

[11] See e.g. Hansmann, H. and R. Kraakman (2001) "The End of History for Corporate Law," *Georgetown Law Journal* 89, 439; Bebchuk, L (2005), "The Case for Increasing Shareholder Power," *Harward Law Review* 118, 833.

[12] See e.g. Romano, R. (2004), "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," *Yale Law & Econ Research Paper 297*; Bainbridge, S. (2003), "Director Primacy: The Ends and Means of Corporate Law", *Northwestern University Law Review* 97, 547.

Shareholder Democracy in the EU

The first such a concept of shareholder democracy in the EU was introduced by the recommendations of the High Level Company Law (HLG) Experts on takeover regulation in the EU in 2002.[13] It was stated that shareholders are the owners of the company and they should take the ultimate decision to sell the company or not.[14] Unreservedly, it was implied that shareholder democracy will be achieved through the principle of proportionality between the risk-bearing capital (non-voting stock) and decision-making on the one hand and the breakthrough rule on the other (by imposing the 1S1V).[15]

The implications of the recommendations have been widely analyzed in the law, economic and finance scholarship. The consensus that emerged out of that research is that the HLG recommendations on revamping takeover market in the EU was a mixed bag of tools and instruments unable to promote more active and efficient takeover markets across the EU.[16] Most strikingly, however, in an attempt to promote

[13] See Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, EC, Brussels, January 10, 2002.

[14] See *Id.*

[15] See *Id.*

[16] See e.g. Bebchuk, L. and O. Hart (2002), "A Threat To Dual-class Shares", *Financial Times,* 31 May, claiming that instead of promoting economic efficiency, the break-through rule will push companies to substitute dual-class capitalization by other structures of control such as pyramids. These structures can further exacerbate problems related to monitoring, incentives and liquidity; see e.g. McCahery, J., (2003), "The Economics of Takeover Regulation in the EU", *CEPS Working Paper Series,* argues that costs of the break-through rule exceed its benefits. The board neutrality and break-through rules are neither necessary nor sufficient conditions for ensuring the level playing field. Each rule should be assessed on its own merits and efficiency implications; see e.g. Coates, J. (2003) "Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?", *Harvard Law and Economics*

shareholder democracy and decision-making in the EU, these recommendations could at best demote and at worst oppress real ownership rights, and hence shareholder democracy, since they were effectively redefining the concept of ownership, shifting it to non-owners i.e. those with cash-flow rights and giving them the power to decide to sell the company or not.[17]

The idea of shareholder democracy in the EU surfaced once again in 2002 following the second report of the HLG on company law reform in the EU[18] and in 2003 following the EC's Communication.[19] While corporate Europe has tried to un-puzzle how representative representative shareholder democracy should become in the EU, for

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Discussion Paper 450, effectively claiming that the break-through rule is not any better neither politically nor economically vis-à-vis the status quo.

[17] There are two fundamental self-contradicting principles on which the recommendations are based. The first is that shareholders are the owners of the company and any decision to sell or not to sell the company belongs to them. Hence, managers should be banned from taking any takeover defense measures (the board neutrality rule). The second principle is that there should be proportionality between risk bearing capital and control in connection to the pre-bid structures and mechanisms of the target company so that the bidder can breakthrough the barriers for exercising control in the target company and exert control in proportion to his holdings (the break-through rule).

The concept of the risk-bearing capital has been previously unknown to economics although the economic logic would associate it with cash flow rights. The HLG proposed that upon the acquisition of 75% of risk bearing capital the bidder can break-through any mechanisms and structures that deviate from the 1S1V. Hence, in the context takeover the claimants of residual cash flow rights acquire residual voting rights based on the arguments that the former bears the ultimate effects of their decisions, whereas holders of control rights part with some of their control rights. Paradoxically, in the takeover context this would mean that in the pursuit of the promotion of shareholder democracy in the EU i) ownership rights are shifted from the real owners to the non-owners; and ii) the decision to sell or not the company is not in the hands of the owners but in the hands of the non-owners.

[18] See Report of the High Level Group of Company Law Experts on A Modern Regulatory Framework for Company Law in Europe, 2002.

[19] See *supra* note 1.

EC policy-makers, corporate governance in general and shareholder democracy in particular seemed to be a forgone conclusion alla Mead (1922) i.e. "corporate governance is associated with representative government and is aimed at mirroring social, economic and political institutions of a wider society into the level of corporations."[20] To implement "democratic representation" at the level of corporations EC policy-makers opted for the 1S1V as an instrumental choice thereof.

Against this background, the next section briefly discusses economic theory of ownership and corporate voting.

B. ECONOMICS OF OWNERSHIP AND CORPORATE VOTING: A BRIEF OVERVIEW

Economic theory of ownership and ownership structure unequivocally states that ownership matters.[21] Not only does ownership matter but also its distribution and exercise do insofar as it is generally argued that the degree of distribution of ownership is an equilibrium response to the company's operating conditions,[22] and, hence, they

[20] See Mead, E. (1922), *Corporation Finance*, New York, D. Appleton and Company.

[21] See e.g. Jensen M. and C. Smith, (1984), *The Modern Theory of Corporate Finance*, New York: McGraw-Hill Inc. The authors extend the basic framework of Modilgiani and Miller (1958) (see Modilgiani, F. and and M. Miller (1958), "The Cost of Capital, Corporation Finance and the Theory of Investment", *American Economic Review* 48, 261) to include variables such as such as taxes, bankruptcy costs, and agency costs, they argue that the mix of financial claims (including debt and equity) affects the value of the firm since any changes in the mix change the firm's total cash flows; Mayers, D. and C. Smith, Jr. (1986), "Ownership Structure and Control: The Mutualization of Stock Life Insurance Companies", *Journal of Financial Economics* 16, 73; Masulis, R. (1987), "Changes in Ownership Structure: Conversions of Mutual Savings and Loans to Stock Charter", *Journal of Financial Economics* 18, 29;

[22] See e.g. Demsetz, H. (1983), "The Structure of Ownership and the Theory of the Firm", *Journal of Law and Economics* 26, 375; Demsetz, H. and K. Lehn (1983) "The Structure of Corporate Ownership: Causes and Consequences", *Journal of Political Economy* 93, 1155.

affect the performance of the company and the value thereof.[23] Moreover, it is submitted that managerial performance and managerial incentives depend on the degree of concentration of ownership and their stake of ownership in the firm.[24]

Consequently, corporate voting mechanisms are critical in the context of exercising ownership over a wide range of corporate affairs. The 1S1V is a corporate voting mechanism that makes control exactly proportionate or equiproportional to capital invested by tying cash flow rights with voting rights to these shares. It is based on the assumption that shares have i) economic ownership (cash flow rights) and voting power (voting rights) and ii) cash flow rights should be exactly proportionate to voting rights since shareholders are interested in higher share value, and, hence, will equally vote to promote that interest so that to maximize the value of the company.[25] Moreover,

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[23] See e.g. Wruck, K., (1989), "Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financings" *Journal of Financial Economics* 23, 3; Hertzel, M. and R. Smith (1993), "Market Discounts and Shareholders Gains for Placing Equity Privately" *Journal of Finance* 48, 459; Smith, C., (1986) "Investment Banking and the Capital Acquisition Process", *Journal of Financial Economics* 15, 3; Grossman, S. and O. Hart (1986), "The Costs and Benefits of Ownership: A Theory of Vertical Integration", *Journal of Political Economy* 94(4). Jensen, M. and J. Warner (2000) "The Distribution of Power among Corporate Managers, Shareholders, and Directors", http://papers.ssrn.com/abstract=173459; Grossman, S. and O. Hart (1986), "The Costs and Benefits of Ownership: A Theory of Vertical Integration", *Journal of Political Economy* 94(4); Grullon, G. and G. Kanatas (2001), *Managerial Incentives, Capital Structure, and Firm Value: Evidence from Dual-class Stock*, Rice University Working Paper.

[24] See e.g. Jensen, M., and W. Meckling (1976) "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", *Journal of Financial Economics* 3, 305; Jensen, M., (1986) "Agency Costs of Free-Cash-Flow, Corporate Finance, and Takeovers", *American Economic Review* 76, 323.

[25] For more details see e.g. Easterbrook, F. and D. Fischel (1983) "Voting in Corporate Law", *Journal of Law and Economics* 26, 395 arguing that "…it is not possible to separate the voting right from the equity interest and that someone who wants to buy a vote must buy stock too;" Easterbrook, F. and D. Fischel (1991), *The Economic Structure of Corporate Law*, Harvard University Press; Black, B. and R.

to Easterbrook and Fischel (1983), the 1S1V would be a "mechanism by which stocks are valued [so that] the price reflects the terms of governance and operation."[26]

The 1S1V is also generally designed as a legal counter balance to the managerial power along with the lines of the central concept of modern corporation namely separation of ownership and control.[27] Since minority shareholder-owners inherently suffer from collective action problems to monitor manager-shareholders in dispersed ownership structures (e.g. the US), the argument goes, the 1S1V is one of the instruments to reduce the divergence between the interests of managers and shareholders and discipline wayward managers through the threat of replacement or the exercise thereof.[28]

In the US, the 1S1V was introduced by the NYSE in 1926 and subsequently abandoned in 1986. [29] In the EU, the 1S1V is already a rule in some Member States. The Demnior study e.g. which examines 300 FTSE-Eurofirst 300 highlights that:[30]

Kraakman (1996) "A Self Reinforcing Model of Corporate Law", *Harward Law Review* 109, 1911 arguing that "The case for the one share one vote rule turns primarily on it's ability to match economic incentives with voting power…"

[26] See Easterbrook, F. and D. Fischel (1983) *supra* note 25.

[27] For more details on separation of ownership and control see e.g. Berle, A. and G. Means (1932), *The Modern Corporation and Private Property*. New York: Macmillan.

[28] See Black, B. and R. Kraakman (1996) *supra* note 25 in which the authors argue that "The case for the one share one vote rule turns primarily on it's ability… to preserve the market for corporate control as a check on bad management." See also Jensen, M. and J. Warner (2000) *supra* note 23.

[29] For a comprehensive history of the one-share-one-vote rule in the US see e.g. Seligman, J. (1986), "Equal Protection in Shareholder Voting Rights: The One-Share-One-Vote Controversy", *George Washington Law Review* 54, 687.

[30] See Application of the one share – one vote principle in Europe, March 2005, http://deminor.org/articles.do?id=3479

- 65% of all companies analyzed apply the 1S1V. Deviations occur in most markets but are widespread in France, The Netherlands and Sweden (see Figure 1 in the Annex for more details).
- There is variety of exceptions to the 1S1V. Multiple voting rights are used by 20% of analyzed companies and are widely used in France, Sweden, and the Netherlands (see Figure 2 in the Annex for more details on multiple voting rights and Figure 3 for all types of deviations by the frequency of each type of deviation).

Against the background, the following section evaluates how the 1S1V can influence shareholder value and whether it can be a right choice for shareholder empowerment.

C. IS THE 1S1V OPTIMAL?

The link between the 1S1V and shareholder welfare is a critical one, since to the extent the 1S1V can be an optimal economic arrangement in terms of best promoting shareholder value predetermines whether the 1S1V can be a right policy instrument for EU intervention in the pursuit of shareholder democracy in the EU. The (in)efficiency implications of the 1S1V have been broadly discussed in law, finance and economic literature. At best there are conflicting views as whether deviations from the 1S1V increase or reduce corporate value.[31]

Is the 1S1V the best policy instrument to achieve shareholder democracy in the EU? To answer this question, the following subsections examine and present an in-

[31] See e.g. Jarrel, G and A. Poulsen (1988), 'Dual-Class Recapitalizations as Antitakeover Mechanisms: The Recent Evidence', *Journal of Financial Economics* 20, 129. Partch, M. (1987), "The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth" *Journal of Financial Economics* 18, 313.

depth analysis of the 1S1V in the context of complete contracts, incomplete contracts, takeovers, pyramidal holdings and derivative instruments.

1. *The 1S1V and Complete Contracts*

Corporate voting structures in general and the 1S1V in particular are irrelevant in the world of complete contracting, costless enforcement and homogenous shareholders. If all contracts are complete, then the corporate players are capable of i) fully foreseeing all the future contingencies, ii) stating the course of actions with respect to each contingency, and iii) writing comprehensive contracts at zero cost.[32] Moreover, if the knowledge of the states of the nature is common among shareholders i.e. the states are dependent upon observable and verifiable variables, the third parties can easily observe and enforce contracts. This means that there are no principle-agent problems of moral hazard and/or adverse selection. Ex-ante complete contracting leaves no room for ex-post residual decision-making, opportunism and divergent/heterogeneous preferences. And, hence, all shareholders have identical tastes or preferences. Costless enforceability of contracts eliminates incentive and coordination problems, and hence, invalidates the very necessity of ownership in general and the 1S1V in particular. The initial distribution of ownership and the 1S1V do not matter in this context since resources will eventually end up at their highest value use and economic efficiency will be maximized.[33]

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[32] See e.g. Coase, R. (1937), "The Nature of the Firm", *Economica* 4, 386.

[33] This implies three types of efficiency: productive, allocative and distributive efficiency. Productive efficiency refers to the costs of goods and services produced in the economy. Allocative efficiency refers to the allocation of resources to the production of the goods and services consistent with the societal preferences. Distributive efficiency refers to the efficiency by which the output and services produced are delivered to the society at given disposable incomes and market prices.

2. *The 1S1V and Incomplete Contracts*

As soon as the assumption of contractual completeness is abandoned, the incomplete contracting paradigm implies that shareholders are rational maximizers of their welfare but only boundedly so. Moreover, there are agency costs of contracting, monitoring and opportunism which give a rise to divergent incentives. Hence, incomplete contracts validate the necessity of ownership. Not only does ownership become relevant in this context but also its distribution. If ownership and its distribution matter, then instruments of exercising ownership in general and the 1S1V do as well. The issue then becomes how 1S1V influences shareholder value! There might be two alternative explanations in the incomplete contracting paradigm i.e. transaction costs and concentration of ownership both driven by heterogeneous preferences.

Transaction Costs

In the transaction cost paradigm, the optimality of 1S1V can be explored based on the relationships between the nature of investment, the degree of its specificity (re-deployability/liquidity) and the cost of finance.[34] It can be generally argued that since different modes of finance have different costs, in this framework the level of asset specificity determines preferences for different modes/preferences of finance. Moreover, the degree of specificity of investment determines different incentives and divergent preferences, and hence, undermines the very basis of the 1S1V namely that of "similar if not identical shareholders."[35]

[34] For more information see e.g. Demsetz, H. (1983), "The Structure of Ownership and the Theory of the Firm", *Journal of Law and Economics* 26, 375; Grossman, S. and O. Hart (1986) *supra* note 14; Hart, O. (1995), *Firms, Contracts and Financial Structure*, Oxford University Press; Hart, O. and J. Moore (1990), 'Property Rights and the Nature of The Firm', *Journal of Political Economy* 98(6), 1119.

[35] See e.g. Easterbrook, F. and D. Fischel (1983) *supra* note 25.

Low asset specific investments can be easily financed by debt (lower transaction costs), while high asset specific investments ought to be financed by equity (lower transaction costs). This logic is very simple. As the degree of asset specificity of the investment increases, the degree of its liquidity shrinks and the transaction cost of its monitoring increases. As the liquidity shrinks, the value of pre-emptive rights decreases so the cost of debt finance increases. Thus, higher (lower) costs of debt finance induce the firm to choose lower (higher) cost equity finance for investment projects. More importantly, ownership and ex-post residual decision-making should be allocated in such a way that information asymmetries and high agency cost of monitoring (post contractual costs) could be minimized. This can be achieved through extending adequate incentives to the party (ies) making the most specific relationship specific investment through conferring controlling residual voting power to this party(ies).

In this context, the 1S1V implies that high and low agency cost shareholders, or alternatively shareholders with divergent preferences, get the same ex-post decision-making power (voting rights). This increases information asymmetries, agency costs of monitoring and reduces the incentives of the high agency cost factor(s), thus inducing further costs on the company and its value. Hence, the 1S1V becomes a sub-optimal voting mechanism in the world of incomplete contracts and heterogeneous shareholders as defined by the degree of specificity of their investments.

Against this background, economic optimality would suggest that, in order to maximize shareholder value, there should be complete separation between voting rights and cash flow rights. The party(ies), which makes the most particular relationship specific investment should have the full non-fragmented menu of residual ex-post decision-making power in the company.

Ownership Concentration

Another framework that can shape the optimality debate of the 1S1V is the degree of concentration of ownership once again driven by non-identical shareholders in terms of their preferences for control. Since the 1S1V is an instrument of distribution and exercise of power within the corporation, efficiency implications thereof vary with a degree of concentration of ownership.

The degree of ownership concentration varies across the world's advanced economies. There are different ownership structures e.g. across the both sides of the Atlantic with the most important difference being the presence of a controlling shareholder(s) in the EU.[36] The latter signifies the fact that unlike the US, ownership and control are not fully separated in the EU.

Not only is there a striking difference between ownership concentration in the EU and the US, but the main categories of owners and the instruments of ownership vary significantly as well. Unlike the US e.g. ownership in continental Europe has been highly concentrated through such instruments as pyramidal holdings, ownership cascades, disproportionate class of shares, voting trusts and voting caps (see Table 1 and 2 in the Annex for more details).[37]

Corporate voting instruments be it in the US or EU, have evolved historically as a result of different preferences for control and liquidity as well as the wider set institutions of ownership and historic market structures. Dispersed ownership structures e.g. inherently suffer from a problem which in the economic literature is generally known as a "free rider problem." The essence of the problem is that in dispersed ownership structures, there will be generally lack of monitoring since costs and benefits of monitoring will be shared disproportionally: costs of monitoring will be incurred by an individual shareholder willing to do so, while the rest of shareholders and

[36] For more details see e.g. Barca. F. and M. Becht (2001), *The Control of Corporate Europe*, Oxford University Press.

[37] See e.g. Bennedsen, M. and K. Nielsen (2002), "The Impact of Break-through Rule on European Firms", Copenhagen School of Economics Working Paper; Faccio, M. and L. Lang (2002), "The Ultimate Ownership of Western European Companies", *Journal of Financial Economics* 65(3), 365.

stockholders will only benefit from any such monitoring without any contribution. The lack of monitoring will further exacerbate the conflict of interest between minority shareholders and the board by effectively allowing managers to benefit from diverting corporate resources through e.g. related party transactions (see e.g. Gilson and Gordon 2003), undertaking projects targeted to their needs and ends (see e.g. Demsetz and Lehn 1985), pursuing visionary projects (see e.g. Jensen 1993) or enhancing their human capital (see e.g. Shleifer and Vishny 1989).[38]

Hence, in the context of dispersed ownership structures, the 1S1V is designed as an instrument in the wider set of the core and supporting institutions of corporate governance to mitigate agency costs of monitoring and incentives between minority shareholders and managers i.e. to reinforce shareholder primacy through monitoring and disciplining corporate boards.

While concentrated ownership structures effectively overcome the free rider problem between small shareholders and managers by giving controlling shareholders the power and benefits of control, yet they introduce another type of agency problem i.e. between controlling and non-controlling shareholders. Through different instruments of exercising control, like those employed in the EU, controlling shareholder(s) can effectively curb managerial power. Thus, by promoting their own interest through general oversight, majority shareholders also promote that of the minority. Yet, ownership cascades, pyramids, voting trusts e.g. allow controlling shareholders unilaterally and disproportionally benefiting from their holdings through

[38] See Gilson. R. and J. Gordon (2003), *Controlling Controlling Shareholders*, Columbia Law School WP No. 228; Jensen, M. (1993), "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems", *Journal of Finance* 48(3), 831; Demsetz, H. and K. Lehn (1983), "The Structure of Corporate Ownership: Causes and Consequences", *Journal of Political Economy* 93, 1155; Shleifer, A. and R. Vishny (1989), "Management Entrenchment: The Case of Manager-Specific Investments", *Journal of Financial Economics* 25(1), 123.

related party transactions, control premia and freeze-out transactions to the detriment of non-controlling shareholders (see e.g. Gilson and Gordon 2003).[39]

The latter has two important ramifications for the optimality of the 1S1V. First, is that the degree of concentration of ownership determines different incentives and divergent preferences, and hence, undermines the very basis of efficiency of the 1S1V namely that of "similar if not identical shareholders."[40]

Second, in the context of controlling structures in general and in the EU in particular, the 1S1V designed to discipline self-interested managers is not a suitable policy instrument since in the EU the nature and magnitude of agency problems is not between minority-shareholders and wayward managers, but between minority and majority shareholders. Hence, it would be a more viable and efficient step forward if EC policy-makers could introduce measures that could effectively constrain the private benefits of control by controlling shareholders and ensure equal treatment of all shareholders.

In any case a proper disclosure regime for such transactions is a key to limit the amount of control benefits accrued by controlling shareholders. The *IAS 24 Related Party Disclosures* e.g. already defines how a transfer of resources, services, or obligations between related parties regardless of whether a price is charged, the nature of related party transaction, information about outstanding balances should be disclosed to allow for an understanding of their potential effects should be disclosed.[41] Moreover, the IAS 24.16 mandates disclosure of management compensation, and, hence, constrains the ability of majority shareholders to compensate themselves as e.g. board

[39] See Gilson and Gordon (2003) *supra* note 38.

[40] See Easterbrook, F. and D. Fischel (1983) *supra* note 25.

[41] See IAS 24 for more details.

members of the company.[42] Furthermore, the IAS 1.96 (97) require the company to present a statement of changes in equity as a separate component of the financial statements which further makes equity change transactions more transparent, and, hence, reduces the need for extensive legislating in this area.[43]

Against this background, the EU e.g. can at best reinforce strictly accounting standards that might be further complemented by the introduction of rigorous standards of judicial review.[44]

[42] See IAS 24.16 mandating disclosure of key management personnel compensation in total and for each of the following categories: i) short-term employee benefits; ii) post-employment benefits; iii) other long-term benefits; iv) termination benefits; and v) equity compensation benefits. Key management personnel are those persons having authority and responsibility for planning, directing, and controlling the activities of the entity, directly or indirectly, including all directors (whether executive or otherwise).

[43] See IAS 1. 96 requiring to show i) profit or loss for the period; ii) each item of income and expense for the period that is recognized directly in equity, and the total of those items; iii) total income and expense for the period (calculated as the sum of (i) and (ii)), showing separately the total amounts attributable to equity holders of the parent and to minority interest; and iv) for each component of equity, the effects of changes in accounting policies and corrections of errors.

Moreover, according to the IAS 1.97 the following amounts may be additionally presented in IAS 1.96 or they may be presented in the notes: i) capital transactions with owners; ii) the balance of accumulated profits at the beginning and at the end of the period, and the movements for the period; and iii) a reconciliation between the carrying amount of each class of equity capital, share premium and each reserve at the beginning and at the end of the period, disclosing each movement.

[44] See Gilson and Gordon (2003) *supra* note 38 arguing that subjecting any transaction between the controlling shareholder and the company to standards of business judgment and intrinsic fairness can effectively mitigate the degree of extraction of private benefits of control.

3. *The 1S1V and Takeovers*

The implications of voting mechanisms in general have been widely analyzed in the context of proxy contests for corporate control.[45] In particular, a rigorous analytical framework of (non)optimality conditions of the 1S1V in the takeover context have been developed by the pioneering works of Grossman and Hart (1988), and Harris and Raviv (1988).[46] Despite the fact that the proposed settings differ in certain respects,[47] the authors' general conclusion is that the distribution of voting rights affects the value of the firm and under qualifying conditions (almost never), the 1S1V is Pareto optimal.[48]

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[45] See e.g. Edelman, P. and T. Randall (2003) "Voting Models, Corporate Elections and Takeover Bids", http://ssrn.com/abstract=429160; Gilson, R. and A. Schwartz, (2001) "Sales and Elections as Methods of Transferring Corporate Control, http://ssrn.com/abstract=249067; Bebchuk, L. and O. Hart, (2001) "Takeover Bids vs. Proxy Fights in Contests for Corporate Control", *Harvard John M. Olin Discussion Paper Series* 336.

See Easterbrook, F. and D. Fischel (1991), *The Economic Structure of Corporate Law*, Harvard University Press; Gilson, R. (1987), "Evaluating Dual Class Stock: The Relevance of Substitutes", *Virginia Law Review* 73, 807 arguing that only companies with weak corporate governance voting structures employ takeover defenses in general and multiple classes of shares in particular.

[46] See Grossman, S. and O. Hart (1988), "One-share-one vote and the Market for Corporate Control", *Journal of Financial Economics* 20, 175; Harris, M. and A. Raviv (1988), "Corporate Governance: Voting Rights and Majority Rules", *Journal of Financial Economics* 20, 203.

[47] Grossman and Hart concentrate on the maximization of the economic value and assume that the subjective probability of a small shareholders being pivotal in the takeover context is zero. Harris and Raviv in contrast also analyze maximization of the social value and assume that small shareholders can be pivotal in the takeover context.

[48] The criterion associated with the name of Vilfredo Pareto. The underlying premise of the Pareto criterion is the individual welfare. It says that a group is better off if a) every individual is better off, or b) at least one member of the group is better off without anyone else being worse off.

Based on the concepts of private and public benefits of control that accrue to the board and shareholders respectively, Grossman and Hart (1988) argue that the 1S1V maximizes the value of the firm as compared to dual class capitalization, since dual-class capitalization coupled with the following qualifying conditions might allow for control to be transferred to potentially inefficient bidder who enjoys private benefits of control: i) shareholders have the same preferences, ii) control is concentrated through a dual class structure with 50:50 split between the voting and non-voting shares having equal cash flow rights, iii) the incumbent management does not enjoy private benefits, iv) there is only one party in the control contest obtaining significant private benefits and v) the bidder bids only for the voting stock, while the holders of non-voting stock incur the costs of inefficient management without benefiting from any control premium.[49]

Under these qualifying assumptions, however, the 1S1V would eliminate the possibility of inefficient management taking control. Any bidder should acquire all the outstanding shares of the company at a share price trading under the incumbent management. Hence, the 1S1V outperforms any dual class structure by maximizing the public (economic) value of the firm.[50]

The second seminal contribution made by Harris and Raviv (1988) presents a tradeoff between social and economic optimalities and argue that this tradeoff determines the optimality of the 1S1V.[51] Social optimality is achieved when the sum of the private and public benefits is maximized. The 1S1V in combination with the simple majority rule becomes socially optimal because it is capable of replacing wayward

[49] See *Id.*

[50] A point should be made here that any rational bidder will incorporate foreseen costs associated with the one share one vote rule into his bid price which might imply that the public value of the firm is not necessarily maximized under one share one vote rule in this context.

[51] See *supra* note 46.

management. The party capable of running the company more efficiently gets the control. However, social optimality generally is achieved to the detriment of economic optimality. The authors show that any dual class structure with a full separation of voting rights and cash flow rights maximizes the public value of the firm. Nevertheless, while economic efficiency endows shareholders with more benefits, it does not necessarily ensure the victory of the best management team. Consequently, efficiency might suffer as a result of the 1S1V.

Under qualifying conditions, not having such a voting rule leads to inefficient acquisitions from the nonvoting shareholders' perspective - in a Grossman & Hart type setting, but as the magnitude of the inefficiency essentially turns on whether private benefits for bidders are very large, one wonders how relevant is such an assumption. The assumption of only one party in the control contest is not realistic. As the number of contestants increase, concentrated voting power allows for "squeezing out" higher public benefits from private benefits. The party in the control contest that can enjoy the highest control benefits is also the one that can run the company more efficiently (see also the transaction cost and incomplete contracts arguments). This also makes the holders of non-voting stock better off.

Moreover, the fundamental presumption of shareholders being homogenous value-maximizers is indefensible. The literature has long emphasized the role of the elements of behavioral and cognitive psychology in price performance and price behavior over time, and, hence, heterogeneity of preferences of corporate players.[52] They are not identical insofar as their preferences are concerned since they have limited

[52] For more details see e.g. Kahneman, D and R. Mark (1988) "Aspects of Investor Psychology", *Journal of Portfolio Management* 24, 52; Choi, S. and A. Pritchard (2003) "Behavioral Economics and the SEC", *Stanford Law Review* 56, 1.

non-identical cognitive capacities to store, process, and interpret information.[53] Different corporate players also have different perceptions or biases of the market and its trends. They use behavioral and judgmental elements such as i) biases of motivated reasoning, ii) biases of self-confidence, and iii) biases of flawed statistics to find out and discover valuable information in the face of informational incompleteness.[54] Consequently, the way corporate players make judgments on stock performance and the way in which they determine and express their respective preferences e.g. define the way they are different from each other in their preferences and the way this difference reflect upon stock returns and volatility.[55]

Against this background, the existence of value-increasing deviations from the 1S1V is further supported by various authors. Shleifer &Vishny (1986, 1988), Hirshleifer &Thakor (1994), and Hirshleifer (1995) e.g. claim that deviations from the 1S1V are necessary to extract the highest value from the bidder.[56] Zingales (1994, 1995) and Gromb (1996) further argue that dual class capitalizations with complete separation between voting and non-voting stock increases the efficiency of the bid.[57] Burkart et al

[53] See Simon, H. (1955) "A Behavioral Model of Rational Choice", *Quarterly Journal of Economics* 69, 99.

[54] See Hirshleifer, D. (2001) "Investor Psychology and Asset Pricing", *Journal of Finance,* 64, 1533; Tversky, A. and D. Kahneman (1974), "Judgment Under Uncertainty: Heuristics and Biases", *Science* 185, 1124.

[55] See Goldstein, W. and R. Hogarth (1977), *Research on Judgment and Decision Making*, Cambridge University Press.

[56] See Hirshleifer, D. and A.V. Thakor (1994), "Managerial Performance, Boards of Directors and Takeover Bidding", *Journal of Corporate Finance: Contracting, Governance and Organization* 1, 63; Shleifer, A. and R. Vishny (1989), "Management Entrenchment: The Case of Manager-Specific Investments", *Journal of Financial Economics* 25(1), 123.

[57] See Zingales, L. (1994), "The Value of the Voting Right: A Study of the Milan Stock Exchange Experiment", *Review of Financial Studies* 7(1), 125; Zingales, L. (1995), "What Determines

(1998) additionally contend that deviations from the 1S1V might be desirable to mitigate post-takeover agency problems absent the mandatory bid rule.[58]

Jensen and Warner (2000) advance the non-optimality debate of the 1S1V by concluding that deviations from the 1S1V can create more shareholder wealth since they allow for capturing more benefits of control from the successful bidder.[59] Coates (2001) further claims that it is largely misleading to believe that the 1S1V promotes takeovers while any dual class is a takeover defense.[60] Even if dual-class shares can be seen as a takeover defense, Bebchuk et al. (2002) conclude that takeover defenses in general have little or no impact on the bid outcome. [61]

Martin and Partnoy (2004) further undermine the feasibility of the 1S1V in the context of takeovers arguing that voting arbitrage can effectively make the 1S1V a suboptimal corporate voting mechanism and demote shareholder value.[62] Arbitrageurs, the argument goes, can destroy the shareholder value in the takeover context, if their net holding position of shares as defined by the difference between pure holdings and the short positions is negative. The destruction can take two forms. First, shareholders with a net negative position can block value enhancing takeovers to profit from their short positions. Second, the same shareholders can vote for suboptimal tender offers. In both

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the Value of Corporate Votes?", *Quarterly Journal of Economics* 110, 1047; Gromb, D. (1997), *Is One-Share-One-Vote Optimal?,* MIT Discussion Paper.

[58] See Burkart, M. et al (1998), "Large Shareholders, Monitoring and the Value of the Firm", *Quarterly Journal of Economics* 112, 693.

[59] See Jensen and Warner (2000) *supra* note 23.

[60] See Coates, J.C. (2001), "Explaining Variations in Takeover Defenses: Blame the Lawyers", *California Law Review* 89, 1301.

[61] See Bebchuk, L. et al. (2002), "The Powerful Anti-takeover Force of Staggered Boards: Theory, Evidence, and Policy", *Stanford Law Review* 54, 887.

[62] See Martin, S., and F. Partnoy (2004), "Encumbered Shares", papers.ssrn.com/abstract=621323.

cases, the more shareholder value is destroyed, the more profits these shareholders make.

At et al (2006) explore how voting structure, asymmetric information and private benefits determine the takeover outcome and conclude that generally the 1S1V is not optimal in terms of promoting more value-increasing bids.[63]

Consequently, in the context of promoting more active and value enhancing corporate takeover market, the 1S1V can not be a value enhancing corporate voting mechanism in the EU. Paradoxically, it can promote self-interested incentives and value-destroying takeovers, or even worse a takeover defense.

4. The 1S1V and Pyramids

Pyramidal holdings are designed as hierarchically intermediated chains of affiliated companies through a top-down chain of control as a vehicle to achieve desired degree of tradeoff between liquidity and control. [64] Through such structures the ultimate owner(s) retain most of the voting power of the chain and mostly externalize financial, risk bearing or liquidity costs. It gives an opportunity or "default options" to the ultimate owner(s) to diversify risks and allocate resources across a "portfolio of companies and contracts" while ensuring necessary voting control is retained over the chain. Moreover, for a given value of the company, it is cheaper to establish and

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[63] See At, C., M. Burkart and S. Lee (2006), "Security Voting Structure and Bidder Screening."

[64] See e.g. Wolfenzon D. (1999) "A Theory of Pyramidal Ownership", *University of Michigan Business School. Working Paper;* For the tradeoff between liquidity and control, see Coffee, J. (1991) "Liquidity versus Control: The Institutional Investor as Corporate Monitor", *Columbia Law Review* 91, 1278; Aghion, P., P. Bolton, and J. Tirole (2004), "Exit Options. in Corporate Finance, Liquidity vs. Incentives", *Review of Finance* 8, 1, however, contend that highly speculative liquid markets necessitate more not less monitoring; Becht, M. (1999), "European Corporate Governance: Trading Liquidity Against Control," http://ssrn.com/abstract=161014.

manage a pyramidal holding instead of a group of horizontally structured companies, since the latter requires significantly higher equity investment, lower leverage, and, hence, higher costs of management vis-à-vis pyramidal holdings.

Though some authors document that pyramidal holdings can create value through "internal capital markets", [65] it is also submitted that such structures allow for maximum extraction of private benefits by the ultimate owner(s).[66] Moreover, as compared to negative impact that dual-class capitalization has on liquidity and incentives, pyramidal holdings have much larger negative impact on these variables.[67] Shleifer and Vishny (1997) e.g. argue that "…large owners gain nearly full control of the company and are wealthy enough to prefer to use firms, to generate private benefits of control that are not shared by minority shareholders…".[68] La Porta et al. (2002) further posit that weak minority protection rules induce expropriation of outside shareholders which is an increasing function of the controlling shareholders owning less cash flow rights.[69]

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[65] For value creation of pyramidal holdings see e.g. Williamson, O. (1975) *Markets and Hierarchies: Analysis and Antitrust Implications*, The Free Press, New York; Stein J. C. (1997) "Internal Capital Markets and the Competition for Corporate Resources", *Journal of Finance* 52, 111; Billet M. T. and Mauer D. (1999) "Cross Subsidies, External Financing Constraints, and the Contribution of Internal Capital Market to firm Value", *University of Iowa, Working Paper*.

[66] See e.g. Bebchuck A. L., Kraakman R., and Triantis G. (2000) "Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights", *in Concentrated Corporate Ownership*, R. Morck edition.

[67] See *Id.*

[68] See Shleifer, A., and W. Vishny, (1997), "A Survey of Corporate Governance," *Journal of Finance* 52, 737.

[69] See La Porta, R., Florencio, A. Shleifer, and R. Vishny, (2002), "Investor Protection and Corporate Valuation," *Journal of Finance* 57, 1147.

Nevertheless, Becht (1999) argues that the imposition of legal rules/voting mechanisms aimed at strengthening minority rights can indeed have negative effects on corporate performance insofar as they can reduce monitoring incentives and shrink liquidity.[70]

Against this background, imposition of the 1S1V can induce companies valuing more control through non equiproportional capitalization to switch to pyramidal structures.[71] Particularly, in the EU characterized with majority ownership and a wide variety of non equiproportional capitalization, this can be a plausible scenario. Hence, even if 1S1V is mandated in the EU, instead of meeting its policy objectives, it might indeed affect minority rights and lead of minority abuse as compared to dual class capitalization e.g. From a policy perspective, it might sound prescriptive to ban pyramidal holdings. Nevertheless, it might be insurmountable task since i) this would be almost tantamount to prohibiting industrial groups most of which take the form of pyramidal holdings in the EU and ii) or to discover pyramids and prescribe limitations on their use.[72]

Even if EC policy-makers somehow manage to ban pyramidal structures, derivative instruments may effectively allow achieving the same economic effect of separation of cash flow rights from voting rights of the same shares but at much higher costs, however, as it is discussed in the next section.

5. *The 1S1V and Market for Votes*

[70] See Becht, M. (1999) *supra* note 64.

[71] See *Id.* See also Berglof, E. and M. Burkart, (2003) “European Takeover Regulation”, *Economic Policy* 36, 173, further extending this argument in the context of takeover regulation

[72] For a similar argument, see also Ferrarini, G. “Share Ownership, Takeover Law and the Contestability of Corporate Control”, http://papers.ssrn.com/abstract=265429.

Political, legal and economic scholarships have long dealt with the issue of vote-trading in the political markets and equilibrium conditions thereof.[73] Vote-trading and political logrolling e.g. have long been a part and parcel of political dynamics in many advanced democracies.[74] Moreover, the public and social choice scholarships have extensively concentrated on the political bargains, vote-trading outcomes as well as stability and optimality properties thereof.[75]

There is an important analogy that can be drawn from the choice of the decision and legal rules in the political market to the choice of decision and legal rules in the corporate market. Borrowing from Karlan (1999) it can be argued that on the one hand, shareholders' rights to vote and voting rules have a powerful expressive individual and collective choice functions insofar as they reveal individual and collective choices.[76] On the other hand, if an individual rational value-maximizing shareholder think of their votes as simply something to be auctioned to the highest bidder, they are likely to see

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[73] See e.g. Buchanan, J. and Tullock G. (1962), *The Calculus of Consent, Logical Foundations of Constitutional Democracy*. Ann Arbor: University of Michigan Press; Stigler, G. (1972), "The Law and Economics of Public Policy: A Plea to the Scholars", *Journal of Legal Studies* 1,1; Schwartz, T. (1977), "Collective Choice, Separation of Issues and Vote Trading", *American Political Science Review* 71, 999; Pelzman, S. (1990); "How Efficient is the Voting Market?" *Journal of Law and Economics* 33, 27.

[74] For more details on logrolling see e.g. Buchanan and Tullock (1962) *supra* note 67; Mueller, D. *et al* (1972), "The Social Gains from Exchanging Votes: A Simulation", *Public Choice* 13, 55; Bernholz, P. (1973), "Logrolling, Arrow Paradox and Cyclical Majorities", *Public Choice* 15, 87.

[75] See e.g. Becker, G. (1983), "A Theory of Competition Among Pressure Groups for Political Influence", *Quarterly Journal of Economics* 98, 371.Becker, G. (1985), "Public Policies, Groups, and Dead Weight Costs", *Journal of Public Economics* 28,329. Bernholz, P. (1973), "Logrolling, Arrow Paradox and Cyclical Majorities", *Public Choice* 15, 87.

[76] For a basic taxonomy in the political context see Karlan, P. (1999), "Symposium Commentary: Politics By Other Means" *Virginia Law Review* 85, 1697.

the sole purpose of the corporate governance process as maximization of their own short-term self-interest.[77]

In this light, corporate vote-trading and corporate logrolling was advanced by the advance of capital markets and derivative instruments thereof that introduced many exchange mechanisms in the market for corporate votes and vote trading conducive to different preferences in terms of control. These techniques allow for de facto decomposition of the 1S1V i.e. separation of cash flow rights from voting rights to those shares. These instruments endow with de facto ability, in consonance with all legal requirements, to possess more or less voting rights as compared to cash flow rights of those shares depending on the need and the nature of a derivative transaction.

There are many decomposing techniques derivative techniques such as stock lending, equity swaps, direct and indirect hedges and the like enable corporate actors to retain formal control while outsourcing some or most of the cash flow rights.[78] Stock lending e.g. allows for separating cash flow rights from voting power so that the borrower ends up with enough voting power to push through desired decisions during general meeting of shareholders while the lender retains cash flow rights in exchange for some fee. This is a relatively easy technique in the US e.g. where stocks amounting to 99% of market capitalization can be lent and borrowed.[79]

Another technique to decompose the 1S1V is the use of collars in which corporate insiders hedge by taking a put and a call positions simultaneously to limit their possible risk through fixing the downside and upside. Any such operation effectively decomposes the 1S1V by allowing retaining voting powers while reducing

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[77] See *Id.*

[78] For insider hedging and collars see e.g. Bettis, J., J. Bizjak and M. Lemmon (2001), "Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders", *Journal of Financial and Quantitative Analysis* 36, 345.

[79] See D'Avolio, G. (2001), *The Market for Borrowing Stock*, Harvard University.

cash flow exposure. Bettis et al (2001) e.g. ague that in the US, senior executives of listed companies use collars for 36% of their holdings which allows outsourcing 25% of their cash flow exposure.[80]

Shareholders can also combine pure shareholdings with a short position shareholding to decompose the 1S1V. Martin and Partnoy (2004) e.g. argue this combination makes such shareholders at best indifferent to the shareholder value (when the net cash flow position is zero as a result of holding exactly the same number of shares and a short position in that share) and at worst interested in the destruction of shareholder value (when the net cash flow position is positive as a result of holding more shares in the short position as compared to traditional holding).[81]

Hu and Black (2006) further analyze taxonomy and implications of security derivatives that allow for "decoupling" cash flow rights from voting rights attached to the same share and conclude that such separation is indeed value destroying, and worse yet, as compared to dual-class recapitalization does not require a shareholder vote.[82]

The possibility and opportunity for corporate vote trading and de facto decomposition of the 1S1V, changes both shareholder preferences and reflection of the intensity thereof in the corporate decision making process. In this context, the 1S1V simply becomes a starting point or an initial entitlement in the market for corporate votes. The decomposition of the 1S1V emerges to be the exchange mechanism through which individual shareholders express or reveal the relative strength and intensity of their preferences, or, alternatively, shareholders acquire more votes on issues which are

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[80] *Id.*

[81] See Martin and Partnoy (2004) *supra* note 62.

[82] See Hu, H. and B. Black (2006), "Empty Voting and Hidden Ownership: Taxonomy, Implications, and Reforms", http://ssrn.com/abstract=887183; See also Hu, H. and B. Black (2006), "Hedge Funds, Insiders, and Decoupling of Economic and Voting Ownership in Public Companies", http://ssrn.com/abstract=874098.

more valuable to them in exchange for weak preferences on other issues. Any such vote trading would occur until the marginal benefit of acquiring one more vote on a given issue is equal to the marginal cost thereof.

Against this background, an unequivocal answer the corporate finance provides is that even if the 1S1V is a mandatory rule, this does not preclude application of different derivative techniques to decompose and de facto separate cash flow rights from voting rights attached to the same share. Moreover, any such decomposition may distort incentives and advance destruction of shareholder value instead of promoting it. This may be further exacerbated by the fact decomposition does not require any kind of formal shareholder vote.

At the same time, borrowing from Buchanan and Tullock (1962), it can contended that permitting those shareholders who feel strongly about an issue to compensate in some ways those whose opinion is only feebly held can result in a great increase in the well-being of both groups, and the prohibition of such transactions will serve to prevent movement toward the conceptual shareholder optimality surface under almost any definition of this term.[83] "With all side payments prohibited, there is no assurance that collective [shareholder] action will be taken in the most productive way."[84]

[83] See Buchanan, J. and G. Tullock (1962), *The Calculus of Consent, Logical Foundations of Constitutional Democracy*, University of Michigan Press.

[84] See *Id.*

SUMMARY REMARKS

Generally, EC policy-makers have not submitted a burden of proof that establishing shareholder democracy and enforcing the 1S1V will rebuild investor confidence, protect shareholders and third parties as well as foster business competitiveness and efficiency across the EU. Opting for harmonized mandatory 1S1V across the EU, EC policy-makers don't even adequately substantiate why this measure is justified at the level of the Union in light of standards of subsidiarity and proportionality i.e. bearing the burden of proving that Member States are not able to implement this measure as efficiently as it could be implemented at EU level, and mandating the 1S1V is proportional to the objective pursued. Instead, the ubiquitous characteristic of the EU law-making: mandatory harmonization yet another time overshadowed the economic rational of intervention.

While trying to make the case for the 1S1V, a very important open question if not disregard to the diversity of core and supporting institutions of corporate governance in the EU such as traditionally concentrated ownership structures, multiple class of votes and complex mechanisms of retaining control and balancing liquidity of shares remains open. Moreover, if the 1S1V was so value-maximizing why rational shareholders and managers in the pursuit of increasing capacity to raise capital have not always adopted the governance technology of the 1S1V in the EU and/or why given the pressure and scope of global operations, "governance and voting technologies" differ across the Member States' economies. Accordingly, if the 1S1V was so value-enhancing, one would widely expect to observe that at the absence of top-down imposition of the rule there would have been a bottom-up evolution thereof i.e. i) companies going public with provisions for the 1S1V in the charters and/or ii) Member States' legislatures intensively lobbying to provide for the 1S1V in their respective jurisdictions and at the level of the EU. Since none has been a dominant phenomenon in the EU, one can argue that the 1S1V at least is not as valuable as it is presumed.

Furthermore, if the absence of a mandatory 1S1V was so disempowering shareholders in the EU, and controlling shareholders have expropriated minority shareholders, one would expect to see a highly dysfunctional system of corporate governance in the EU in general, and capital flowing to less productive use in the EU in particular. Nevertheless, empirical evidence shows just the contrary. On average the stock markets in the EU have performed relatively well since 1982, with returns comparable to the US levels (see Table 3 in the Annexes). In terms of macroeconomic performance the indicators look quite good as well. From 1970 to 2000, real income of the EU was almost constant at approximately 70% of the US (see Table 4 in the Annexes). The level of productivity of the EU has increased over the same period from 65% to 90% of that of the US. On average, the EU total factor productivity has been even higher than that of the US over the period of 1980 to 2000 (see Table 5 in the Annexes).

Against this background, the conclusion this article draws from the law, economics and finance literature is that 1S1V is neither a sufficient nor a necessary condition for shareholder democracy in general and shareholder empowerment in the EU in particular. Despite the fact that the 1S1V is more politically attractive, it is suboptimal in terms of its economic efficiency. Even if the EU hypothetically manages to disperse ownership in the EU, which is in the light of the EU Takeover Directive is an insurmountable task, the 1S1V is clearly not a value enhancing mechanism in itself at best and at worst is associated with deadweight social losses. The most striking is the fact, however, that even in traditional 1S1V jurisdictions like the US, the advance of capital markets and corporate derivative securities effectively allow for decomposition of the 1S1V. Paradoxically, any such decomposition can distort incentives and lead to the destruction of shareholder value. Consequently, trying to promote shareholder wealth, EC policy-makers might instead promote the destruction thereof through the 1S1V.

Moreover, there is already an ample lesson from sixty years of US corporate history providing a clear example for policy intervention. The growing recognition of the fact that a “long-standing commitment to encourage high standards of corporate democracy” as reflected by individual standards of “corporate responsibility, integrity and accountability to shareholders” as an ideological underpinning of the 1S1V isn’t attractive concept led to the abolition of the 1S1V mandatory rule in the US.[85]

Consequently, a nagging question arises like what is next? There might be two policy alternatives for EC policy-makers. The first alternative is to refrain from taking any action at EU level. Instead, in the light of concentrated ownership structures in the EU, shareholder empowerment can be achieved through reinforcing the role of non-executive directors in the areas of potential conflict of interest between majority and minority shareholders, rigorously enforcing the IAS disclosure rules and disclosure triggering standards, and possibly introduce some standards of review governing significant conflict of interest transactions.

The second alternative can be the introduction of an opt-in or an opt-out provisions in the Member States with respect to the rule. The opt-in Member States would allow companies to opt into the statutory 1S1V provision. The opt-out Member States would allow companies to opt out of the 1S1V either by charter or bylaw amendments. In the light of the exemptions from the break-through rule of the EU Takeover Directive, this approach is also consistent with the body of the EU law. Self-regulatory approach can be further complemented by rigorous harmonized transparency requirements and enforcement thereof. As soon as companies make their corporate governance arrangements in general, and, voting, economic ownership structures and decision-making rules in particular publicly available during the IPO and the post-IPO stages through periodic disclosures to allow investors to make informed decisions, there is no reason to believe that constraining investors’ and issuers’ choice with respect to a

[85] For quotations see Loss, L. and J. Seligman (2003), *Securities Regulation,* 3rd eds.

voting and decision rules by law is a right option to pursue.[86] It might be also beneficial to require US-type of disclosure schedules such as rights attached to securities, directors and officers, compensation, long and short positions, articles of incorporation, bylaws.[87]

In the IPO stage, rational investors could discount price of securities with voting and decision rules disenfranchising shareholder rights, and, hence, increase the cost of capital of the company. Alternatively, rational investors could pay the fair value, and, hence, decrease the cost of capital of the company if the company offers more shareholder friendly voting and decision rules. Consequently, rational managers or controlling shareholders who recognize that the 1S1V matters e.g. in terms of reducing the cost of the capital of the company, would adopt such a mechanism even if it is not a mandatory rule. In the post-IPO stage, disclosure of any changes of voting and decision rules through proxy statements, quarterly, semi-annual and annual reporting can have a similar effect to those of the IPO stage.

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[86] For a choice of law debate see e.g. Guzman, A. (2000) "Choice of Law: New Foundations", *Boalt Working Papers in Public Law*. Paper 81; Choi, S. and A. Guzman (2001), “Choice and Federal Intervention in Corporate Law”, *Virginia Law Review*. 87, 961;

[87] For US disclosure schedules see e.g. the Item 9 of Form S-1 with respect to the corporate governance rights of the securities being sold; Item 11(k) of Form S-1 with respect to directors and officers; Item 11(l) with respect to executive compensation; Item 16(a) with respect to the articles of incorporation, bylaws, and other documents or contracts specifying the rights of security-holders.

ANNEXES

Table 1. Instruments of Separation of Ownership and Control in the EU

	Sample	Controlling Owner (%)	Pyramid Ownership (%)	Cross Ownership (%)	Owning Family (%)
AT	88	81.82	20.78	1.14	80
BE	104	71.15	25.00	0.00	80
FIN	92	41.30	7.46	0.00	69.23
FR	522	64.75	15.67	0.00	62.20
DE	631	59.90	22.89	2.69	61.46
ER	26	42.31	9.09	0.00	77.78
ES	465	44.30	16.00	0.22	62.50
IT	181	58.76	20.27	1.13	70.00
NO	98	38.78	33.90	2.04	66.67
PT	68	60.29	10.91	0.00	50
SW	149	48.32	15.91	0.67	73.47
UK	721	43.00	21.13	0.00	75.85

Source: Faccio, M. and L. Lang (2002) "The Ultimate Ownership of Western European Companies", *Journal of Financial Economics* 65(3), 365.

Table 2. Differentiated Voting Rights in Europe

Country	Number of companies	Proportion of companies with differentiated voting rights (%)
Sweden	334	0.55
Italy	208	0.41
Finland	129	0.36
Denmark	210	0.33
UK	1953	0.24
Ireland	69	0.23
Austria	99	0.23
Germany	704	0.18
France	607	0.03

Spain	632	0.00
Portugal	87	0.00
Belgium	130	0.00

Source: Bennedsen & Nielsen (2002). The Impact of a Break-through Rule on European Firms', Discussion Paper 02-10, Centre for Economic and Business Research, Copenhagen.

Table 3. Stock Market Performance: the EU vs. the US*

	US	Europe
From 1982	1222%	1145%
From 1987	436%	426%
From 1992	164%	113%
From 1997	28%	13%
From 2001	-32%	-34%

* From January 1 of the given year through end of December 2002.
** *Source:* Holmstrom, B. and S. Kaplan (2003), *The State of US Corporate Governance: What's is Right and What's Wrong?* NBER WP 9613.

Table 4. PPP GDP per person, PPP GDP per hour, and Hours per person, 1970 and 2000: US, EU and France. (US=100)*

	GDP Per Person		GDP Per Hour		Hours Per Person	
US	100	100	100	100	100	100
Europe	69	70	65	91	101	77

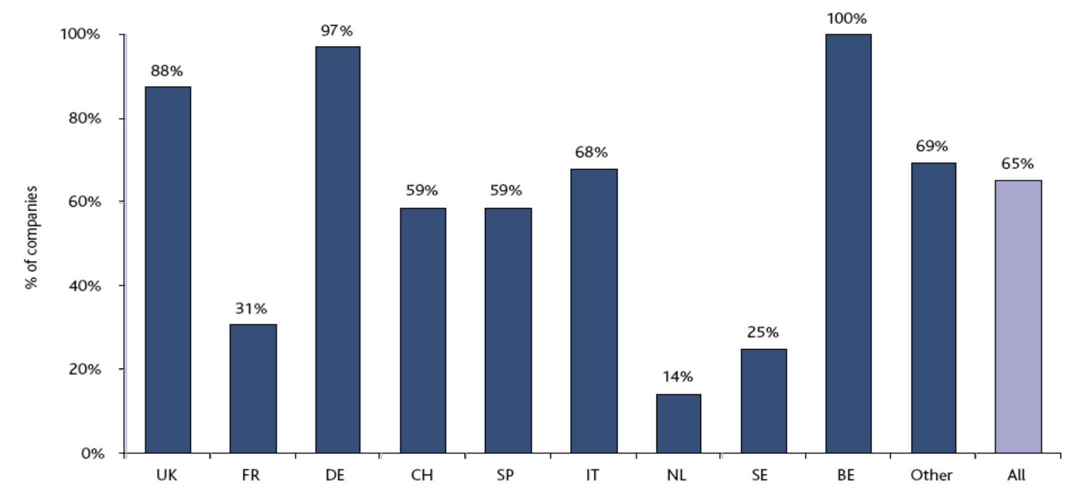
**Source:* Blanchard, O. (2004), *The Economic Future of Europe*, NBER WP 10310.

Table 5.Total factor productivity growth: U.S., EU, and France, 1980-2000. (Percent per year)*

	1980's	1990's	90-95	95-2000
US	0.91	1.06	0.74	1.39
Europe	1.45	1.04	1.36	0.72

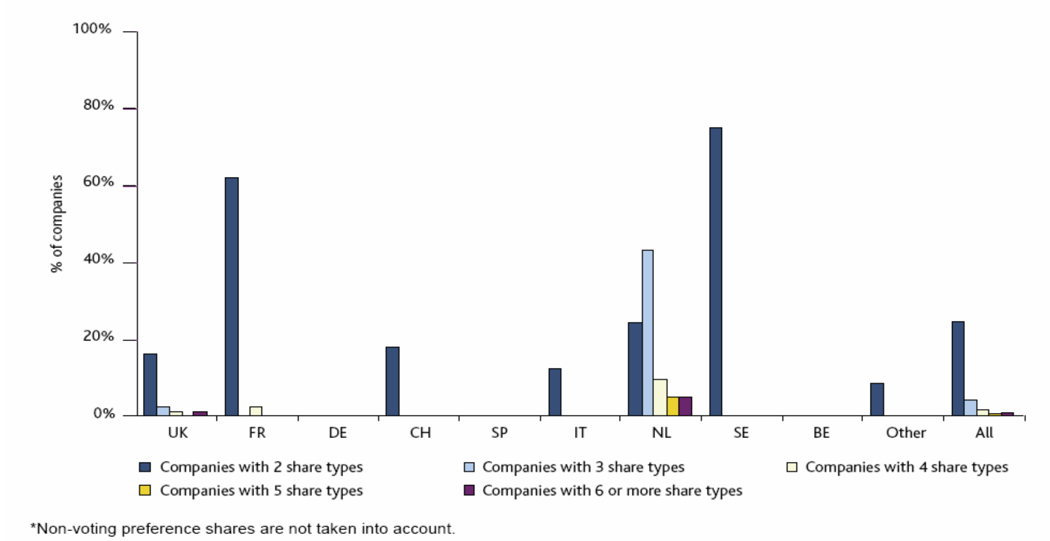
*Source: Blanchard, O. (2004), *The Economic Future of Europe*, NBER WP 10310.

Figure 1: Companies Applying The 'One Share - One Vote' Principle in the EU



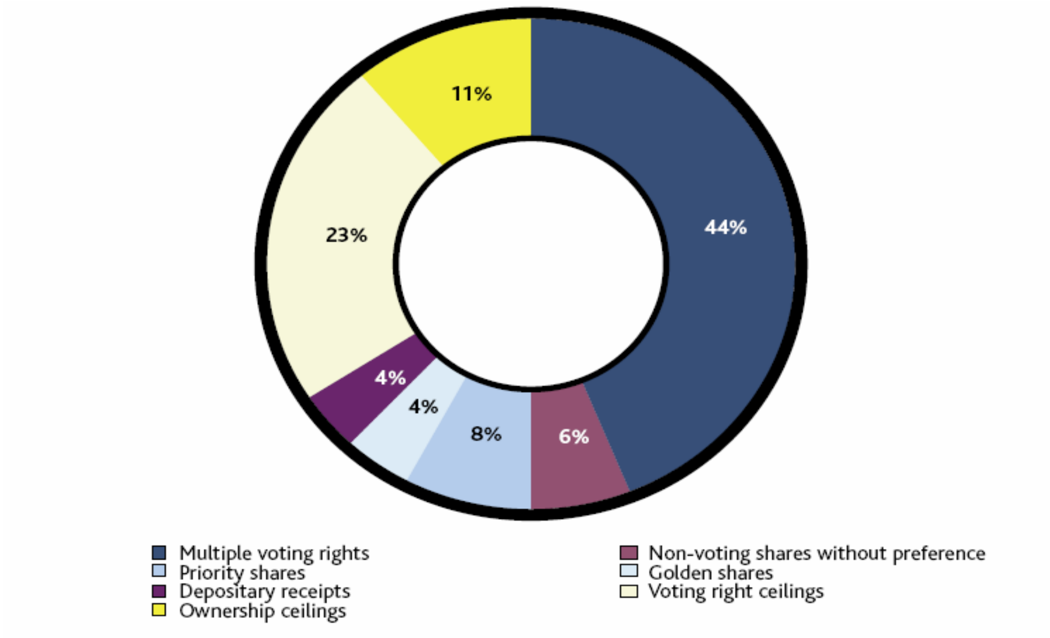
Source: Application of the one share – one vote principle in Europe, March 2005, http://deminor.org/articles.do?id=3479

Figure 2. Number of Share Types in European Companies



Source: Application of the one share – one vote principle in Europe, March 2005, http://deminor.org/articles.do?id=3479

Figure 3. Exceptions to the 'One share - one vote' Principle in the EU by frequency of each type of exception



Source: Application of the one share – one vote principle in Europe, March 2005, http://deminor.org/articles.do?id=3479