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Towards Shareholder Vote on Equity Issuances

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TOWARDS SHAREHOLDER VOTE ON EQUITY ISSUANCES

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New share issuances are capable of severe corporate governance consequences for the issuer and should be considered fundamental changes. Several recent Delaware cases confirm the severity of new share issuances, showing that the transactions have been used to affect the ownership structure of the firm, with the goal to either dilute or strengthen the participation of identified shareholders. U.S. law adopts a management-centric approach to the transaction, which is more focused on its economic side and seems consistent with the traditional view of public corporations with dispersed shareholders. However, this legal framework does not seem responsive to shareholders' interests anymore.

The institutionalization of the shareholder base of public firms has increased the average concentration of the ownership structures and the shareholders' powers. This Article identifies several instances of conflicts between the insiders and the outsiders, where shareholders carry a strong interest in avoiding the dilution of their voting power. Moreover, the entire fairness analysis proves to be flawed in that it fails to consider that the value of voting rights is highly subjective both for controllers and minority shareholders. Managers may take advantage of the tool, exploiting either the value or the voting rights of the existing shareholders. The claim of this Article is to increase the shareholders' power in U.S. law.

The comparative analysis helps identify possible tools. Namely, European legal systems set forth both the preemptive right and the requirement of the existing shareholders' approval. After having identified the flaws of the preemptive right provision — mainly due to the information asymmetry that affects outsider shareholders — this Article puts up a new framework requiring mandatory approval of new share issuances. Certain recent Italian cases witnessed a successful opposition

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by the outsider shareholders, who cast a negative vote and prevented the completion of the transaction. The value of the proposed rule in this Article declines depending on the presence of a controlling shareholder. Namely, while in non-controlled firms all the shareholders should be entitled to cast their vote, in controlled firms, the controller should vote only if the issuance does not strengthen her position, in order to avoid tunneling issues.

Authoritative studies debated the increase of shareholders' powers in public firms. Other essays focused on the issue of midstream recapitalizations and the protection of the minority shareholders in controlled firms. This Article analyzes a wide range of new share issuances both in controlled and in non-controlled firms, considering the possible incentives underlying the decision to enter into the transaction. The impact of the transaction is not trivial since, among other reasons, any debate on shareholder engagement and activism is frustrated as the insiders are empowered to easily dilute the "noisy" outsiders at will.

I. INTRODUCTION

The issuance of new shares is an immediate corporate way to raise additional equity capital. This statement is equally applicable to each case regardless of a firm's features such as the country of incorporation, the listing of its securities, the size and the governance, and transactions' features such as the purchasers' identity and the new share price. However, depending on the combination of these traits, an equity issuance may cause several additional effects. Namely, according to this Article, it is a fundamental change considering its potentially massive impact on the ownership structure and the governance of the issuer.

In February of 2013, Steel Partners Holdings, L.P. ("Steel Holdings") entered into a settlement agreement with the board of directors of ModusLink Global Solutions ("ModusLink"), after acquiring the public stocks of ModusLink since 2011, and reaching a stake granting 14.9 percent of the voting rights.[1] Pursuant to the agreement, ModusLink privately issued shares and warrants to Steel Holdings, which increased its ownership to 29.9 percent and, as of December 2016, owned approximately 35.62 percent of the outstanding shares.[2] In December of 2017, in order to fund an acquisition, the Special Committee and the Board of ModusLink approved a capital raise through the issuance of convertible preferred stocks to the alleged controller.[3] The initial conversion price was at a 31.5 percent premium over the previous day's closing price of the stock, significantly increasing Steel Holding's voting power from 35.62 percent to nearly half (*i.e.*, 46.76 percent).[4] The board further approved the issuance of the equity grants to three members affiliated with Steel Holdings, which, together with its affiliates, reached beneficial ownership equal to approximately 52.3

1. Reith v. Lichtenstein, No. 2018-0277-MTZ, 2019 WL 2714065, at *2 (Del. Ch. June 28, 2019).
2. *Id.* at *2.
3. *Id.* at *4.
4. *Id.*

percent.[5] Therefore, over the years, Steel Holdings achieved majority control of the issuer, taking advantage of both: (i) the 2013 private placement; and (ii) the 2017 equity financing transaction that was under review in the dispute.[6]

In July of 2014, in the context of the purchase of another company — Lorillard, Inc. ("Lorillard"), exchanged for both stocks and shares — Reynolds American, Inc. ("Reynolds American") issued new shares to its forty-two percent shareholder British American Tobacco PLC ("British American Tobacco"), preventing the latter from being diluted by the transaction.[7] While the issuance might facially seem to not affect the governance of the firm — in that the alleged controller does not increase its ownership stake — this is not the case. In fact, pursuant to the transaction entered into with Lorillard, the shareholders of the latter would own approximately fifteen percent of Reynolds American: due to the issuance (reserved to British American Tobacco), only the public shareholders of Reynolds American were affected by the entrance of Lorillard's shareholders into the ownership structure of the firm.[8] Therefore, the impact on the issuer's governance was not trivial.[9]

In May of 2017, Surgery Partners, Inc., a Delaware corporation with a concentrated ownership structure ("Surgery Partners"), and its controlling stockholder, H.I.G. Capital, LLC ("HIG"), entered into a series of interrelated transactions that provided, among other things, that: (i) HIG would sell its fifty-four percent common stock stake to an affiliate of Bain Capital Private Equity, LP ("Bain"); and (ii) Surgery Partners would issue to Bain newly created convertible preferred stocks in exchange for $310 million.[10] These preferred stocks voted with the common stock and provided for some tailored terms enabling Bain to further lock the control of the issuer. Namely, holding half of these newly issued preferred stocks (regardless of a possible dismissal of the common stocks) empowered Bain to prevent Surgery Partners from entering into a number of corporate governance and

5. *Id.* at *5.

6. *See id.* at *1–3 (detailing the background surrounding Steel Holdings' majority control status).

7. Corwin v. Brit. Am. Tobacco, PLC, 821 S.E.2d 729, 731 (N.C. 2018). Note that the ruling of the Supreme Court of North Carolina makes extensive use of Delaware case law.

8. *Id.* at 735.

9. *See id.* at 736 ("BAT's voting power did not increase, but it was allowed to remain constant at the sole expense of plaintiff and the other non-BAT stockholders, whose voting power significantly decreased.").

10. *See* Klein v. H.I.G. Capital, LLC, No. 2017-0862-AGB, 2018 WL 6719717, at *3 (Del. Ch. Dec. 19, 2018).

corporate finance transactions.[11] Also, the recapitalization allowed Bain to reach approximately sixty-six percent of the voting power of the issuer, combining the voting right of common stocks and preferred stocks.[12] Neither a special committee of independent directors was appointed for this purpose nor did the outsider public shareholders' vote on the transaction, which the controller approved by written consent.[13] Also, the structure of the transaction resulted in allegedly incentivizing HIG to underprice the preferred shares issued by the target in order to maximize the price at which Bain acquired HIG's shareholding.

In May of 2018, the Special Committee of the Board of CBS Corp., a dual-class Delaware corporation ("CBS"), entered into a series of actions that, if successful,[14] would have diluted the voting rights of the controlling shareholder,[15] National Amusements, Inc. ("NAI"), from eighty percent to seventeen percent through the issuance of a voting shares stock-dividend to the holders of both voting and non-voting classes of CBS shares.[16] The Special Committee claimed that its move was a response to a threat to the corporation by NAI, as the Special Committee had not recommended the approval of a business combination that the major shareholder had strongly suggested.[17] The Delaware Court of Chancery had to rule on NAI's alleged power to execute an amendment to CBS's corporate charter aimed at requiring a supermajority in order to approve a dividend, and therefore, empowering the controller to veto the transaction at hand.[18]

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11. *See id.* ("As long as Bain retains 50% of the shares of the Preferred Stock issued in the Bain Share Issuance, its affirmative vote is required before the Company can pay dividends other than dividends on the Preferred Stock; enter into a recapitalization, share exchange, or merger; increase its indebtedness; or modify any provision of the Company's organizational documents that would adversely affect the powers of the Preferred Stock, among other things.").

12. *Id.*

13. *Id.*

14. *See* CBS Corp. v. Nat'l Amusements, Inc., No. 2018-0342-AGB, 2018 WL 2263385, at *2 (Del. Ch. May 17, 2018) ("[T]he stock dividend would be conditional 'unless and until the Delaware Courts decide on a record whether it is legally and equitably permissible.'").

15. Ms. Redstone — the controller — was entitled to exercise either directly or indirectly (through her participation in NAI) the heavy majority of the voting rights (approximately 79.6 percent) without holding a proportional economic interest in the firm (approximately 10.3 percent of the economic stake). *Id.* at *1.

16. *Id.* at *2.

17. *Id.*

18. *Id.* ("NAI had executed and delivered consents to amend CBS's bylaws to, among other things, require approval by 90% of the directors then in office at two separate meetings held at least twenty business days apart in order to declare a dividend.").

These public firms' cases illustrate how new equity issuances may affect the ownership structure of a public corporation. U.S. law entrusts insiders with great flexibility in approving the transaction, provided that the price is fair to the corporation. This approach complies with the traditional view of the dispersed public corporation, whose shareholders are mainly (or only) concerned with the economic return of their investment rather than the firm's governance. However, this assumption is not accurate anymore with regard to the ownership base of several corporations. Several shareholders are concerned about dilution, and equity issuance is a powerful tool to address the conflict of interests between insiders and outsiders. Managers may employ this tool to dilute a noisy minority shareholder (*e.g.*, an activist hedge fund) in dispersed public firms or the controlling shareholder (if present) against her will. In a different scenario, should the controller be or have an influence over the decision maker, she may exploit the minority shareholders and strengthen her position in the firm.

This Article studies the issuance of new equity in U.S. firms from a corporate governance perspective and discusses how the transaction affects the interests of existing shareholders. Since this Article focuses on listed companies, it mainly considers Delaware law,[19] although relevant rulings from other states will not be disregarded when dealing with public firms. The research uses a comparative method: U.S. legal framework — having a unique approach in dealing with shareholders' dilution with regard to both the allocation of powers and shareholders' rights — is compared to that of European countries.[20]

After explaining how the transaction may be used to achieve insiders' goals and arguing that the current U.S. legal framework does not adequately protect the outsiders' interests, Part V develops a normative narrative, taking advantage of the comparative experience. Namely, this Article analyzes the two main features (for the purposes of this transaction) of European Union ("EU") regulation — which maintains both the shareholders' vote and the preemptive right — and claims that U.S. law should set forth a voting mechanism to approve new share issuances.

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19. *See* DEL. DIV. CORPS., 2019 ANNUAL REPORT STATISTICS 1 (2019), https://corpfiles.delaware.gov/Annual-Reports/Division-of-Corporations-2019-Annual-Report.pdf (showing that, among other things, 67.8 percent of all Fortune 500 companies are incorporated in Delaware and eighty-nine percent of U.S.-based IPOs in 2019 chose Delaware as the incorporation state).

20. Unless otherwise specified (*e.g.*, when refences will be made to the rules of law set forth by the European Union), the use of the adjective "European" throughout this Article is meant to cover not only the countries of the European Union but all the countries of the European area including, among others, the United Kingdom, whose approach to the transaction at hand will often be considered.

Recent legal scholarship has extensively analyzed all the transactions reallocating control rights in controlled public firms.[21] Other authors have studied the preemptive right in new share issuances, discussing its application and limits.[22] The scope of this Article is not related to the governance problems of a specific type of firm, but rather it focuses on a single transaction (*i.e.*, new share issuances) and extensively covers its application to both controlled and non-controlled firms. While the ultimate goal is to develop a comprehensive legal framework regulating this transaction as a whole, the voting mechanism that this Article suggests requires a different framing depending on the allocation of powers in the firm and who should be deemed outsiders in the transaction.

The remainder of this Article is divided as follows: Part II explains shareholders' concerns about the dilution resulting from the issuance of new shares; Part III positions the issue within the traditional corporate governance conflict between shareholders and managers; Part IV describes the current shareholder powers in the issuance of new shares and their limits; Part V proposes a new legal framework providing for increased powers; and Part VI concludes.

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21. *See generally* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560 (2016) [hereinafter Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*] (positing a new framework of corporate control that emphasizes control of entrepreneurs, which allows them to pursue their idiosyncratic vision); Zohar Goshen & Assaf Hamdani, *Corporate Control, Dual Class, and the Limits of Judicial Review*, 120 COLUM. L. REV. 941 (2020) [hereinafter Goshen & Hamdani, *Corporate Control, Dual Class*] (assessing the reallocation and valuation of control rights and suggesting a stronger reliance on the interpretation of the corporate charters with regard to the allocation of powers to approve such reallocations); Zohar Goshen & Assaf Hamdani, *Majority Control and Minority Protection*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018) [hereinafter Goshen & Hamdani, *Majority Control and Minority Protection*] (contending that minority protection must be balanced with enabling entrepreneur-controllers to pursue their vision); Geeyoung Min, *Governance by Dividends*, 107 IOWA L. REV. (forthcoming 2021) (on file with author) (analyzing the impact of stock dividends on corporate control in dual-class companies from a policy perspective); Lefteri J. Christodulelis, Note, *Seizing the First-Mover Advantage: Resolving the Tension in Delaware Law Between Boards of Directors and Controlling Shareholders*, 120 COLUM. L. REV. 431 (2020) (examining the tension created from transferring control to shareholders).

22. *See, e.g.*, Marco Ventoruzzo, *Issuing New Shares and Preemptive Rights: A Comparative Analysis*, 12 RICH. J. GLOB. L. & BUS. 517, 518 (2013) (examining the differences between the United States and European countries in the limits applied to directors' power to issue new shares and regulate preemptive rights).

II. THE DILUTION ISSUE FROM SHAREHOLDERS' PERSPECTIVE

A plethora of economic literature has delved into the topic of the issuance of new shares, pointing out its genuine feature to be a valuable financing method to raise new equity capital.[23] However, the transaction, depending on its structure, may become a powerful tool for the firm's decision maker, strategically affecting the ownership structure of the issuer. This Part deals with the existing shareholders' perspective on the dilution: Section A focuses on the economic meaning of the term according to Delaware case law and literature; Section B positions the current U.S. legal framework regulating new stock issuances in the comparative context; and Section C suggests that the Delaware approach to dilution is not any more responsive to the concerns of a less dispersed ownership structure.

A. Dilution Meaning in Delaware Law

The term "dilution" should be split into two different, although connected, meanings depending on whether the focus is on financial or voting rights.

i. Economic Dilution

An existing shareholder is economically diluted whenever the overall value of the shares she holds before the issuance decreases because of the transaction. This effect occurs should both of the following requirements be met: (i) the price of the newly issued shares is lower than the market value of the outstanding shares before the transaction; and (ii) the shareholder does not purchase a fraction of the newly issued shares at least equal to the fraction of the shares she originally held (*i.e.*, she does not participate at least pro-rata in the new shares issuance). In fact, a claim for economic equity dilution must be factually based "on the theory that the corporation, by issuing additional stock for inadequate consideration, made the complaining stockholder's investment less valuable."[24]

ii. Voting Dilution

An existing shareholder experiences a voting power dilution whenever her fractional voting power declines because of the issuance. However, in this

23. *See generally* Woojin Kim & Michael S. Weisbach, *Motivations for Public Equity Offers: An International Perspective*, 87 J. FIN. ECON. 281 (2008) (studying the different industrial and financial reasons underlying the decision to issue additional equity).

24. Feldman v. Cutaia, 951 A.2d 727, 732 (Del. 2008); *see also* Cirillo Fam. Tr. v. Moezinia, No. 10116-CB, 2018 WL 3388398, at *16 n.153 (Del. Ch. July 11, 2018) (citing Feldman v. Cutaia, 956 A.2d 644, 655 (Del. Ch. 2007), *aff'd*, 951 A.2d 727 (Del. 2008)).

scenario, the transaction does not have to negatively affect the overall value of the stake that the existing shareholder held before the issuance. A shareholder's participation experiences a voting dilution when: (i) the price of the newly issued shares is equal to or above the market value of the outstanding shares; and (ii) the shareholder does not proportionally purchase the newly issued shares.[25]

Arguably, although the relationship is not reciprocal, the experience of economic dilution is conditioned upon the occurrence of voting dilution (*i.e.*, the transaction must negatively affect the fractional ownership of the shareholder in the firm). In fact, otherwise, in the event of an underpriced issuance, any loss in the value of the shareholder's existing stake is offset by the capital gain that she captures through the purchase of a proportional fraction of the new, underpriced issuance.[26]

Finally, in response to a claim by an allegedly diluted shareholder, a third kind of dilution has been theorized in the context of a Delaware case, the so-called "market price dilution":[27] this is the only supposed dilution scenario where a shareholder suffers a decline in the value of her participation without having her fractional voting rights reduced. In fact, such loss is identified by the fall of the market price of the already issued and publicly traded stocks of the company that occurs following the issuance. Reasonably, such alleged "dilution" is not a direct consequence of the issuance on the shareholder's participation, but of its impact on the market price of the securities. In other words, it does not result from the transaction itself but from the market's perception of its announcement. The court in its ruling explained the decline in the stock price as a consequence of the increase in the overall number of the issuer's shares offered on the market and explicitly endorsed the theory that the demand for the equity securities of a firm is "downward sloping and elastic."[28] Several scholars agreed on this intuition and some of them

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25. *See* Mira Ganor, *The Power to Issue Stock*, 46 WAKE FOREST L. REV. 701, 708 (2011) [hereinafter Ganor, *The Power to Issue Stock*] (explaining voting right dilution and economic dilution); Ventoruzzo, *supra* note 22, at 517.

26. *See* Mike Burkart & Hongda Zhong, *Equity Issuance Methods and Dilution* 3 (Eur. Corp. Governance Inst., Working Paper No. 636/2019, 2019) (noting that the feature of preemptive rights is that as long as the existing shareholders fully exercise their rights, no dilution shall occur, and wealth transfers can be avoided); *see also infra* Section V.A (elaborating further on the statement in the context of the preemptive rights analysis).

27. *See* Ford v. VMware, Inc., No. 11714-VCL, 2017 WL 1684089, at *20 (Del. Ch. May 2, 2017) (suggesting the use of the label "market price dilution").

28. *Id.* (considering the decline in price as the consequence of (i) a "downward sloping and elastic" demand curve for the issuer's shares and (ii) an increase in the supply of the assets, which may occur even though the issued shares belong to a different class).

corroborated such a price-pressures hypothesis with empirical evidence.[29] Other studies argued that stock price reduction is the ultimate consequence of the market's perception that the issuance of shares arises from a board of directors' convincement that the stock is overpriced: in the context of asymmetric information, the market negatively reacts to the transaction.[30] While the scope of this Article does not cover the ultimate economic explanation of the decline in securities price following the stock issuance, it is useful to point out how this "market price dilution" shall not be considered within the dilution issues that this Article analyzes. In fact, taking advantage of the wording of the Delaware Court's reasoning, this "new" dilution concept does not meet the requirement that the company "issue equity that reduces the relative ownership or voting power of the pre-issuance holders."[31]

B. Dilution Protection in Delaware Law: A Comparative Perspective

New share issuances may adversely affect shareholders' interests in several ways, including by: (i) transferring wealth from existing shareholders to the purchasers of new shares; (ii) diluting voting power; and (iii) weakening managers' degree of accountability towards shareholders.[32] Reasonably, only the first item belongs to the category of the economic dilution since items *sub* (ii) and (iii) may result even from a non-underpriced issuance. As a general approach, corporate law is required to address the conflict between the need of the corporation to raise additional capital and the protection of the existing shareholders from dilution. From a policy perspective, a legal system may address this issue in two different ways depending on the nature of the tool that shareholders are granted. Under a

29. *See, e.g.*, Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, 41 J. FIN. 579, 589 (1986); Clifford G. Holderness & Jeffrey Pontiff, *Shareholder Nonparticipation in Valuable Rights Offerings: New Findings for an Old Puzzle*, 120 J. FIN. ECON. 252, 265 (2016) ("There is considerable evidence of downward sloping supply curves for shares of stock."); *cf.* Myron S. Scholes, *The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices*, 45 J. BUS. 179, 207 (1972) (arguing that regressions support the substitution hypothesis against the selling-pressure hypothesis).

30. *See* Paul Asquith & David W. Mullins, Jr., *Equity Issues and Offering Dilution*, 15 J. FIN. ECON. 61, 62 (1986) (reviewing and summarizing several theories on the point debated as of the date of their essay); Massimo Massa et al., *Rights Offerings, Trading, and Regulation: A Global Perspective* 3 (INSEAD, Working Paper No. 2013/120/FIN, 2013); Holderness & Pontiff, *supra* note 29, at 264–66 (exposing further findings concerning the stock price reaction and the negative information that the market infers about the narrower case of a nontransferable rights offering).

31. *Ford*, 2017 WL 1684089, at *20.

32. *See* EILÍS FERRAN & LOOK CHAN HO, PRINCIPLES OF CORPORATE FINANCE LAW 105 (2d ed. 2014).

property rule protection, shareholders may not be expropriated of their assets without their consent, regardless of the consideration that they receive; therefore, they cannot be deprived of their voting rights absent their vote as a class.[33] By contrast, the liability rule protection consists of a deal-oriented approach that enables the decision maker to expropriate the shareholders as long as they receive a fair price in exchange.[34] Although the majority of the legal scholarship has addressed the dichotomy in the context of the conflicted transaction, it is also arguably applicable to new equity issuances, as the comparative analysis between different countries confirms.

The U.S. legal framework — adopting a liability rule — is more focused on protection from the economic dilution rather than from the voting one.[35] To begin with, U.S. rules generally empower directors with the decision to issue new shares and seldom require the approval of the shareholders.[36] Also, existing shareholders are generally not granted the right to participate in the new issuance: in fact, the preemptive right is not either a mandatory or a default provision, and its adoption is very rare in public firms.[37] Namely, the most effective limit on managers' discretion and the most powerful protection of shareholders' interests relies on the application of directors'

33. *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV 1089, 1092 (1972) ("An entitlement is protected by a property rule to the extent that someone who wishes to remove the entitlement from its holder must buy it from him in a voluntary transaction in which the value of the entitlement is agreed upon by the seller."); *see also* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393, 398 (2003) [hereinafter Goshen, *The Efficiency of Controlling Corporate Self-Dealing*] (applying the notion of property rules to group rights and the corporate organization); Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 601 (analyzing the property rule protection from the controlling shareholder's perspective).

34. Goshen, *The Efficiency of Controlling Corporate Self-Dealing*, *supra* note 33, at 398 ("A liability rule allows transactions tainted with self-dealing to be imposed on an unwilling minority but ensures that the minority is adequately compensated in objective market-value terms.").

35. FRANKLIN A. GEVURTZ, CORPORATION LAW 134 (2d ed. 2010) ("[T]he more frequent concern is the potential dilution of the economic worth of the existing shares.").

36. *E.g.*, *In re* Nine Sys. Corp. S'holders Litig., No. 3940-VCN, 2014 WL 4383127, at *28 (Del. Ch. Sept. 4, 2014) ("Delaware law endows the board — not a controller — with the exclusive authority to manage and direct the corporation's business affairs, the foremost example of which is the power to issue stock."); Grimes v. Alteon, Inc., 804 A.2d 256, 261 (Del. 2002) ("Taken together, these provisions confirm the board's exclusive authority to issue stock and regulate a corporation's capital structure."). See *infra* Part IV for a discussion of the main cases triggering the shareholder vote.

37. ROBERT CHARLES CLARK, CORPORATE LAW § 17.1.4 (1986); *see* Edward Rock et al., *Fundamental Changes*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 171, 182 (3d ed. 2017) [hereinafter Rock et al., *Fundamental Changes*].

fiduciary duties to the transaction.[38] By contrast, the default rules of other legal frameworks, including those of EU countries, provide for a two-fold interaction with the shareholders' meeting in that they set forth both the shareholders' vote and the preemptive right.[39] This broader autonomy that U.S. rules grant to the managers is consistent with the overall approach to corporate law: as a seminal comparative corporate law study has pointed out, "EU law and, to some extent Japanese law, accord more attention to [the] management-shareholder conflict in regulating corporate decisions than does the law of U.S. jurisdictions."[40]

However, this manager-friendly attitude proves to have some flaws. Namely, the entire fairness standard is the highest burden that the issuance of new shares currently may have to meet, should the business judgment rule not apply to the transaction, and it mainly consists in an ex-post analysis that the courts carry out on the transaction consideration.[41] Although this rule might seem effective in incentivizing managers to set an issuance price that is fair to the corporation, two different issues may arise.

First, courts apply the entire fairness standard only if they find the transaction to be self-dealing.[42] This approach assumes that absent a conflict of interest, the issuance price is fair. However, satisfying the burden of proof that the transaction is self-dealing is often a problematic task and even a non-self-dealing transaction might harm (certain) shareholders.[43] The above-mentioned case *Corwin v. British American Tobacco PLC*[44] witnessed

38. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 183 (arguing that the duty of loyalty can be at least as effective as preemptive rights, provided that private enforcement institutions are effective); Ventoruzzo, *supra* note 22, at 527 (pointing out the power and flexibility of the fiduciary duties in limiting managers' discretion in the issuance of shares).

39. *See* Directive 2017/1132, of the European Parliament and of the Council of 14 June 2017 Relating to Certain Aspects of Company Law, 2017 O.J. (L 169) 80 ("[D]ecision by the general meeting on the increase of capital"); *id.* at 81 ("Increase in capital by consideration in cash").

40. Rock et al., *Fundamental Changes*, *supra* note 37, at 202.

41. *See* Goshen, *The Efficiency of Controlling Corporate Self-Dealing*, *supra* note 33, at 403 ("The fairness-test protection is no more than a guarantee that the transaction will be fair . . . ."); Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 950 (explaining that the entire fairness review is a two-fold scrutiny test concerning both the process underlying the transaction ("fair dealing") and the transaction price ("fair price")).

42. *See* Goshen, *The Efficiency of Controlling Corporate Self-Dealing*, *supra* note 33, at 397; Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 975 (explaining how the entire fairness standard governs self-dealing).

43. *See* Min, *supra* note 21 (manuscript at 43) (noting that the majority of the cases of directors amending the governance structure of the firm through the distribution of dividends did not witness an express conflict of interest).

44. 821 S.E.2d 729 (N.C. 2016).

similar circumstances.[45] In fact, not only did public shareholders incur a dilution of their voting rights as a result of the issuance but also the economic terms of the transaction seemed to favor the subscriber (and alleged controller) British American Tobacco, which was able to purchase the new shares at a price cheaper than the closing price of the issuer's trading price on the day before the signing of the transaction[46] at a "negative 4.8% premium."[47] Therefore, when the transaction closed, British American Tobacco — due to the further rise in the stock's market price — secured a profit equal to approximately $920 million, which it did not share with the other shareholders.[48] However, Reynolds American's public shareholders failed to prove breach of fiduciary duties in the transaction by either the board of directors or British American Tobacco. Namely, both the North Carolina Business Court and the Court of Appeals dismissed the action against Reynolds American managers, respectively, on the merits and due to lack of standing.[49] With regard to British American Tobacco, the Supreme Court of North Carolina stated that it was not a de facto controlling shareholder[50] in spite of, among other things, its forty-two percent shareholding veto power over the board and role as the main source of equity financing for the issuer; furthermore, it had allegedly behaved aggressively towards the managers in the context of the transaction.[51]

Second, even if the court found the transaction to be self-dealing, there are instances when a fair issuance price does not prevent the transaction from discriminating within the shareholders' class and undermining certain shareholder interests.[52] Indeed, it has been argued that a troublesome situation arises — and the shareholders' protections prove to be insufficient — in the event of a selective sale of the new shares to some existing or new shareholders, provided that the issuance price is fair to the corporation.[53] To this extent, under Delaware law, the firm's decision maker is empowered to effectively issue new shares (to herself or sympathetic investors) and shift the control of the firm, without dealing or negotiating with the minority

45. *Id.* at 733; *see also supra* text accompanying notes 7–9.

46. *Corwin*, 821 S.E.2d at 742.

47. *Id.* at 751 (Hudson, J., dissenting).

48. Corwin v. Brit. Am. Tobacco, 796 S.E.2d 324, 328–29 (N.C. Ct. App. 2016).

49. *Id.* at 338.

50. *See Corwin*, 821 S.E.2d at 743.

51. *Id.* at 753–54 (Hudson, J., dissenting).

52. *See infra* Section II.C.

53. *See* Ventoruzzo, *supra* note 22, at 528 (mentioning other problematic cases, such as the issuance of new "shares to themselves at a fair price" or of the offer to existing shareholders exploiting those who lack funds, although in such cases, a possible and adopted solution consists of requiring a business purpose for the transaction).

shareholders (nor the independent directors), but only the court scrutinizes the fairness of the transaction's price.[54] On a firm level, it has been pointed out that the valuation of a corporation is a problematic task for courts due to the lack of a universal method applicable to all the cases.[55] Furthermore, on a shareholder level, as the following Parts further explain, certain existing or prospective shareholders are willing to subscribe new shares even at a price above the fair market value.[56] Authoritative professors recently addressed the issue, claiming that the entire fairness standard — usually applied to self-dealing transactions — should not be applied to a transaction reallocating control rights since, among other things, the value of control rights is highly subjective.[57] Accordingly, economic models that help courts assess the fair price of the reallocation of control rights "do not exist" differently from what happens in the case of a sale and purchase of assets or entire firms.[58] Arguably, the same reasoning should apply to strategic issuances, which shift the voting rights regardless of whether the ownership structure of the firm is controlled or dispersed and the transaction entails a transfer of control. A decline in the voting power may be a harm by itself even if the firm allegedly receives a fair price; therefore, applying the entire fairness standard to a dilutive issuance of shares that alters the ownership structure of the firm is an inaccurate remedy. This claim is consistent with the argument of recent research that points out how different shareholders value their voting rights, distinguishing between dispersed retail shareholders who seldomly cast their vote and active ones who accumulate them in order to seek corporate changes.[59]

As mentioned above, this feature of the rules governing the issuance of new shares flags a material difference between the United States and several other countries, including the European ones. Multiple explanations might

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54. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 975–77 (addressing the case of the controller engaging in self-dealing transactions). Arguably, the argument applies to all the cases where the decision maker of the firm or the person controlling it engages in similar transactions.

55. *See* Yu-Hsin Lin, *Controlling Controlling-Minority Shareholders: Corporate Governance and Leveraged Corporate Control*, 2017 COLUM. BUS. L. REV. 453, 496 (2017) (applying the reasoning to appraisal proceedings).

56. *See infra* text accompanying notes 170–88.

57. *See generally* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21 (discussing how a test determining which reallocations are allowed and not allowed will eventually revert back to business judgment review).

58. *Id.* at 946.

59. *See* Dorothy S. Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687, 695 (2019) [hereinafter Lund, *Nonvoting Shares*] (using the argument as a ground to advocate a governance system that efficiently distributes voting rights).

be given to the point. In the context of a massive and detailed report carried out on behalf of the United Kingdom government on the topic of new equity issuances ("Myners Report"), it has been indicated that in the United States, the main interest is public firms' access to equity capital rather than protecting shareholders from dilution risk.[60] Arguably, in the United States, the philosophies underlying the nature and the role of the public firm's shareholders are different from that of EU countries. In fact, there appears to be a stronger conception of *purchase* of the equity securities[61] rather than of *subscription* of shares: while the latter commits the shareholders to the execution of the corporate contract, the former shows a mere economic interest in the corporation. The Myners Report found that in the United States, "investors have the limited role of buying and selling without any particular commitment to the governance or long-term strategy of the companies in which they invest."[62] To this extent, EU laws tend to protect the property rights of shareholders through mandatory rules, undermining the flexibility of the managers in amending the financial structure of the firm.[63] A comparative study on freeze-outs pointed out similar differences between the two conceptions and underlined the dichotomy between mere financial and voting rights in the U.S. approach and the "pure 'untouchable' right of property."[64] While the freeze-out transaction is indisputably different from new equity issuances in that its application is limited to controlled companies and is an extreme change to the ownership structure of public firms, the argument can be transposed. Namely, the bottom line is that the U.S. legal system allows greater flexibility in the composition of the shareholders' base as long as the economic value of the shareholders is not exploited.[65]

The described attitude might come from either a cultural and political background or an economic landscape, where the majority of the public companies used to have a fragmented ownership structure.[66] To this latter

60. PAUL MYNERS, PRE-EMPTION RIGHTS: FINAL REPORT 17 (2005), https://webarchive.nationalarchives.gov.uk/20060213221519/http://www.dti.gov.uk/cld/public.htm.

61. *Id.* at 16 (explaining that in the United States, "investors have the limited role of buying and selling without any particular commitment to the governance or long-term strategy of the companies in which they invest").

62. *Id.*

63. *See* Ventoruzzo, *supra* note 22, at 542.

64. Leonardo Pinta, Note, *The U.S. and Italy: Controlling Shareholders' Fiduciary Duties in Freeze Out Mergers and Tender Offers*, 7 N.Y.U. J.L. & BUS. 931, 936 (2011).

65. *See* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 413 (2006) (listing economic rights as one of four "fundamental rights" shareholders have under current law).

66. *See* Ventoruzzo, *supra* note 22, at 542 (suggesting the theory as one of the possible explanations for the different approaches to preemptive rights in the United

extent, the paradigm of the so-called Berle-Means corporation — as defined by Professor Roe — is a public company with dispersed public shareholders.[67] This model results in two main consequences: (i) the power of the managers is strong; and (ii) given that the legal system and the market tend to develop together, the former sets forth provisions protecting the dispersed public shareholders from the managers, based on what were perceived as their main concerns.[68] The U.S. approach perfectly complies with the perception of the so-called Berle-Means corporation, treating the shareholders as investors with the underlying assumption that they do not consider protection from dilution of their respective fractional voting rights a critical priority. This seems to fit within the definition of fragmented dispersed shareholders, who are concerned about the exploitation of the value of their respective investment and likely deem less problematic the reduction in the strength of their respective voting power since, individually, each shareholder is capable of having only a trivial effect on the vote of the shareholders as a class. Section II.C, however, exposes how this model is not any more representative of the majority of U.S. public firms.

While the reason underlining the peculiar and flexible approach of U.S. corporate law to new share issuances is debatable, the potential impact of this transaction on the core corporate governance issues seems to be undisputed. As a final remark, the Myners Report, dated 2005, suggested a connection between the differences in the rules on new equity issuances between the United Kingdom and United States and the features of their respective markets, especially the degree of the shareholders' involvement

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States and Europe; in fact, in EU jurisdictions, shareholders have preemptive rights in new share issuances as a default rule). Note that the Author does not find the explanation fully convincing since it does not apply in the context of close corporations even if the difference between the two systems persists. However, for the purpose of this Article, the argument may still be valid. Indeed, the focus of this Article is on the overall attitude towards new share issuances and the possible interests of public shareholders in avoiding the dilution, rather than on the specific issue of the mandatory preemptive right provision. To this extent, it does not seem unreasonable to explain the traditionally different approach between the two jurisdictions with the different ownership structure of the respective firms and the overall lack of interests of the Berle-Means corporation's public shareholders in keeping their voting power. *See* ROBERT W. HAMILTON, THE LAW OF CORPORATIONS 196 (5th ed. 2000) (reporting frequent implementation of the preemptive right in close corporations, therefore corroborating the intuition that a less dispersed ownership structure might increase the interest in antidilution protections).

67. *See* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 12 (1991); Brian R. Cheffins, *The Rise and Fall (?) of the Berle-Means Corporation*, 42 SEATTLE U.L. REV. 445, 464–70 (2019) (extensively reviewing the reasons underlying the development of the Berle-Means corporation and its evolution).

68. *See* Cheffins, *supra* note 67, at 466–68 (reviewing the of evolution of the U.S. legal system on the point).

in the governance of the public firm.[69] Indeed, it was claimed that the stronger powers and responsibilities of the institutional investors in the United Kingdom, as well as their more active involvement in the governance of the participated firms and the set of long-term goals, enhanced their interest in avoiding dilution.[70] The following Section seeks to undermine the premise of this statement — as far as it concerns the current scenario in the United States — and point out that existing shareholders, given their features and sophistication, carry an interest in avoiding dilution.

C. The New Ownership Structure of the Public Firm and the Enhanced Shareholders' Interests in Effective Anti-Dilution Protections

This Article claims there should be a distinction between the issuance of new shares and other corporate deals such as the sale or purchase of corporate assets.[71] Namely, assessing an equity issuance in the same way as any other possibly overpaid transaction, with the goal of understanding whether the company received too little in exchange for its stocks, seems an oversimplification. Regardless of the fairness of the price, each share carries a value that is beyond its capacity as a tradable security.[72] Therefore, an issuance of new shares is capable of material impacts at the shareholder level, even in a public company.[73] Any equity issuance may affect the position of the individual shareholder within the corporate entity, regardless of the consideration that she receives. Arguably, the shareholders of public corporations have an interest in restricting the flexibility of the managers and downsizing the risk that they affect the ownership structure of the firm, with the ultimate goal of either reducing the voting power of some shareholders or strengthening their insulation.[74]

The analysis of the adverse positions and the incentives of, respectively,

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69. *See* MYNERS, *supra* note 60, at 16–17 (describing the influence shareholders can have in the United States).

70. *See id.* at 17.

71. *See* Min, *supra* note 21 (manuscript at 12, 13) (exposing a similar reasoning with regard to dividend distribution and stressing the "stock's unique and powerful trait," since "stock comes with voting and other rights").

72. *See* Robert Charles Clark, *Vote Buying and Corporate Law*, 29 CASE W. RSRV. L. REV. 776, 778 (1979) ("[O]ne who buys common shares of a company is in fact purchasing not only a residual economic interest in the company, but also a share of the voting power.").

73. *See* Carsanaro v. Bloodhound Techs., Inc., 65 A.3d 618, 655–56 (Del. Ch. 2013) (endorsing the principle that the impact of a new issuance is "felt primarily by the shareholders"). Note that since the case involved a private corporation and the argument was used to broaden the application of the *Gentile* ruling, stating that it is the majority view of Delaware case law would be, at least, questionable.

74. *See supra* text accompanying note 32.

shareholders and managers of the public company requires a *caveat* in order to clarify the use of the terms. The main corporate tension, in the context of an issuance of new shares, concerns that between the issuer's constituencies which, respectively: (a) are empowered to approve the issuance or can substantially influence the decision (*i.e.*, the insiders); and (b) have a passive position in the decision and are exposed to the risk to have their own interests negatively affected in any of the mentioned ways (*i.e.*, the outsiders). To this extent, the directors and officers of the firm will be considered together within the corporation's management in the category *sub* (a).[75] All the shareholders not exercising control in the firm are part of the category *sub* (b). The most problematic task is the allocation of the controlling shareholders in either of the two groups: although one would be tempted to consider the controllers within the decision makers *sub* (a),[76] this Article also considers the case of a conflict between the board and the controlling shareholder, with the former diluting (or trying to dilute) the latter against her will.[77] This Article advocates focusing on the specific transaction and tries to distinguish the position that the controller — if existing in the firm's ownership structure — may have in order to assess whether she should be considered part of the insider managers or of the outsider shareholders.

To begin with, the paradigm of the public corporation as an entity, whose ownership structure is widely fragmented and whose governance mainly witnesses an agency tension between the interests of the dispersed shareholders and managers, is not accurate anymore.[78] The massive presence of institutional investors in the shareholder base has significantly

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75. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 842 (2005) [hereinafter Bebchuck, *The Case for Increasing Shareholder Power*] (adopting this division while warning that within the broad category of the manager, the interests of officers and independent directors sometimes differ and pointing out that the increase in power of independent directors has been a salient corporate governance topic throughout the years).

76. *See, e.g.*, FERRAN & HO, *supra* note 32, at 205 (adopting this approach for the purpose of the transaction at hand).

77. *See infra* text accompanying notes 192–203.

78. *See* Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 498–99 (2018) [hereinafter Lund, *The Case Against Passive Shareholder Voting*] (describing the fall of the Berle-Means corporation and the increasingly concentrated shareholder bases); *see also* Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 92 (2017) [hereinafter Bebchuk, *The Agency Problems of Institutional Investors*] (corroborating the argument of the increased concentration with robust empirical evidence concerning the largest twenty U.S. public corporations as of June 30, 2016); Edward B. Rock, *Institutional Investors in Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 363, 365–67 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018) [hereinafter Rock, *Institutional Investors in Corporate Governance*] (exposing the transformation and the concentration of institutional ownership in U.S. public firms over the last few decades).

increased its average degree of sophistication and concentration.[79] Authoritative scholars relied on such empirical data to claim the need for a new set of corporate governance theories tailored to the current ownership structures.[80]

While such institutional investors are not necessarily actively involved (or according to some scholars, not enough[81]) in the governance of the firm, it has been observed that they vote on core corporate governance matters and often debate with the firm's management on such issues.[82] Recent studies describe the business model of the institutional investors and point out how the size of the stake they usually hold results in an interest in not missing the opportunity to cast their determinative vote in an informed way in order to beneficially impact the firm's performance.[83] Accordingly, the massive economic value of their stake — coupled with a reputational argument to attract additional assets under their management due to their "superior

79. *See* Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U. L. REV. 971, 973 (2019) [hereinafter Hamdani & Hannes, *The Future of Shareholder Activism*] (exposing that "institutional investors today collectively own 70–80% of the entire U.S. capital market" and that in an average large public firm, there are "between three to five money managers, each holding approximately 5–10% of the corporation's stock. Other institutional investors . . . hold smaller percentages, comprising together up to an additional 50% of the corporation's shares"); Zohar Goshen & Sharon Hannes, *The Death of Corporate Law*, 94 N.Y.U. L. REV. 263, 304 (2019) [hereinafter Goshen & Hannes, *The Death of Corporate Law*] (arguing that the shift from retail investors to large, sophisticated ones has resulted in a decline of the use of Delaware courts).

80. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 864 (2013) ("The canonical account of U.S. corporate governance, which stresses the tension between dispersed shareholders and company managers in large public firms, has become factually obsolete and now provides a misleading framework for contemporary corporate governance theorizing.").

81. *See generally, e.g.*, Bebchuk, *The Agency Problems of Institutional Investors*, *supra* note 78 (claiming a lack of incentives for institutional investors in adequately investing in the corporate governance of the participating firms).

82. *See* Gilson & Gordon, *supra* note 80, at 887; Lund, *The Case Against Passive Shareholder Voting*, *supra* note 78, at 501–02 (pointing out the influence that institutional investors have on the governance of firms but also carefully distinguishing between active institutional investors and passive institutional investors, arguing that only the former are effective governance players).

83. *See, e.g.*, Hamdani & Hannes, *The Future of Shareholder Activism*, *supra* note 79, at 979–83 ("[T]he increase in size of the stakes owned by large institutional investors suggests that money managers may capture substantial gains from improved share value at portfolio companies."); Lund, *Nonvoting Shares*, *supra* note 59, at 717 (noting how institutional investors that hold the majority of shares of U.S. public firms "have the resources and sophistication to exercise their votes intelligently, as well as a financial incentive to invest in monitoring and stewardship," although excluding passive funds from this group).

returns" and recognize "faithful efforts" — creates an incentive in retaining the voting power and participating in the corporate decisions even for the passive funds, which charge the lowest fees.[84] This trend is expected to continue in the future. On the point, BlackRock's CEO, in his 2018 letter to the CEOs of the firms in their portfolio, committed to an increasingly intense involvement in the engagement activity with the participated issuers since, among other things, they may not easily dismiss their participation in managing their index funds, contrary to what occurs in the active funds' practice.[85] The 2019 edition of the same annual letter pointed out the materiality of "corporate strategy and capital allocation" as engagement priorities,[86] signaling that the institutional investors are increasingly seeking a voice in business matters, not only in governance matters.[87] A recent study indicated that the increasing percentage of shares of the public companies that index funds — a subgroup within the institutional investors — is attributable to those index funds leaning towards shareholder empowerment.[88] The statement is consistent with the findings of an empirical analysis, which pointed out the unprecedented rise in shareholders' powers that the recent corporate governance charter amendments have caused.[89] This study and evidence, overall considered, suggests that such

84. *See* Hamdani & Hannes, *The Future of Shareholder Activism*, *supra* note 79, at 981; Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders* 12 (N.Y.U. Sch. L., Working Paper No. 18–39, 2019) [hereinafter Kahan & Rock, *Index Funds and Corporate Governance*] (pointing out the relationship between the size of the stake that index funds have and their incentive in voting); *id.* at 31 (explaining how reputational incentives work in index funds' structures in order to gather the necessary information and properly vote).

85. Letter from Larry Fink, Chairman and Chief Exec. Off., BlackRock, to CEOs (2018), https://corpgov.law.harvard.edu/2018/01/17/a-sense-of-purpose/; *cf.* Lund, *The Case Against Passive Shareholder Voting*, *supra* note 78, at 516–17 (explaining her skepticism about the commitment of the so-called "Big Three" to be increasingly involved in the governance of the participated firms and corroborating her view with economic data analysis on costs and staffing resources).

86. Letter from Larry Fink, Chairman and Chief Exec. Off., BlackRock, to CEOs (2019), https://www.blackrock.com/americas-offshore/en/2019-larry-fink-ceo-letter.

87. Hamdani & Hannes, *The Future of Shareholder Activism*, *supra* note 79, at 976.

88. *See* John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 1 (Harv. Pub. L., Working Paper No. 19–07, 2018) ("Against that real-world benchmark, indexation represents a significant shift towards more shareholder power, not less."); William B. Bratton & Simone M. Sepe, *Corporate Law and the Myth of Efficient Market Control*, 105 CORNELL L. REV. 675, 677 (2020) ("The rise of hedge funds and other activist investors has brought an unprecedented shift in power from managers to shareholders, who are now empowered to determine business decisions at publicly traded companies."); *cf.* Cheffins, *supra* note 67, at 447 (claiming that the overall paradigm of the public corporation has not changed so materially that it has changed the passivity of the shareholders).

89. Geeyoung Min, *Shareholder Voice in Corporate Charter Amendments*, 43 J.

empowered and relatively more involved shareholders do not lack interests and incentives in limiting managers' power to dilute their voting influence at will.[90] Namely, the several claims for an improved set of corporate governance principles addressing the change in the status of the public shareholders should not undermine the possible effects of the managers' amendments to the ownership structure itself. In fact, any increase in — or any claim to increase — the shareholders' powers and their engagement in the public companies' governance should not disregard the importance of a fundamental transaction, such as the issuance of additional shares, where the ultimate impact is similar to the creation and purchase of votes.[91] To this extent, fundamental transactions are the premise of any case of shareholder involvement in the governance of the firm.

As a general remark, several of the established powers of common equity shareholders have a direct and proportional relationship to the size of the voting stake that the shareholder holds, including: the right to vote on directors' elections and mergers, to start a proxy fight, or to propose a governance action, as well as to threaten any of these in order to capture managers and directors.[92] On the point, it has been indicated how a share equal to at least twenty-five percent of the issuer's stock would empower the holder to block "empire-building" acquisitions and to exercise a strong influence over the management of the firm and, in extreme circumstances, remove the managers.[93] It has been pointed out that, when informed and motivated institutional investors hold voting shares, they are usually able to achieve a certain degree of influence over the management of firm, despite their belonging to the minority; however, the large majority of their tools build on their voting rights.[94] Therefore, minority shareholders with a significant stake in the context of new share issuances might fear losing their blocking rights and seek to aggressively purchase additional shares.[95]

CORP. L. 289, 303–05 (2018).

90. *See generally* Ganor, *The Power to Issue Stock*, *supra* note 25 (discussing multiple powers of shareholders and their ability to protect their interests so that their voting rights are not diluted).

91. *See id.* at 733.

92. *See* Coates, *supra* note 88, at 6 (exposing the rights that common equity shareholders enjoy).

93. Roe, *supra* note 67, at 12–13.

94. *See* Lund, *Nonvoting Shares*, *supra* note 59, at 741 (mentioning, among other things, the submission of a shareholder proposal, the "vote against board nominees or executive compensation," and the veto of a fundamental change).

95. Jesse M. Fried & Holger Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, 137 J. FIN. ECON. 353, 363 (2020) [hereinafter Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*].

However, this is not always possible, at least in a cost-effective way.[96] The intuition of the shareholders' interests in avoiding voting dilution is supported by the results of a relatively recent economic analysis, which found that shareholders holding more than five percent of the voting rights of a public firm fear dilution of their voting influence that may occur because of the issuance.[97] Note that the case of shareholders whose voting rights exceed five percent captures not only the controlling shareholders but also the significant minority ones.

The bottom line is that there are two main instances when a public corporation's shareholders are concerned about the dilution of their fractional voting power. The first instance involves shareholders who are concerned about dilution are controlling shareholders or, broadly, shareholders who seek to pursue control of the firm. The second and more problematic instance is where one of the shareholders does not seek control but rather aims to exercise influence over the managers without pursuing control. Professors Armour and Cheffins pointed out the distinction between investors seeking influence and those seeking control and their respective business models.[98] Namely, investors seeking influence usually purchase a block that, although does not grant the control of the corporation, enables the investor to exercise pressure over management to achieve changes that are ultimately oriented at increasing the shareholders' value.[99] According to an article within this category, hedge funds seek broader influence than the influence usually exercised by institutional investors.[100] Thus, the position of hedge funds is in a sort of grey area between plain influence and "actual legal control."[101] The development of the market for influence — which investors that "use the influence that accompanies their large ownership positions to discipline management" mainly participate — led to the broadening of the spectrum of the shareholders carrying an interest in retaining their voting power in order to influence the managers, even if such influence is not strong enough to impose any decision (as otherwise is the

96. *See, e.g.*, *infra* text accompanying notes 140–48, 170–88.

97. Thomas Poulsen, *Corporate Control and Underinvestment*, 17 J. MGMT. & GOVERNANCE 131, 132 (2013).

98. Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 58–59 (2011).

99. *See id.* at 58.

100. *See* Anna L. Christie, *The New Hedge Fund Activism: Activist Directors and the Market for Corporate Quasi-Control*, 19 J. CORP. L. STUD. 1, 14 (2019) (explaining how these investors usually seek to actively change the target company either through a proxy context or obtaining a seat on the board of directors).

101. *Id.*

case for controlling shareholders).[102]

In conclusion, although the longer-term interest is often connected to the financial reward, this Section claims that in the context of the public firms' equity issuances, several shareholders carry an additional interest in retaining their fractional voting power. To this extent, it supports the theory of Section B[103] that the entire fairness standard is not an appropriate standard for transactions reallocating voting rights. In addition, a new share issuance may carry the strongest corporate governance implications through the impact on the fractional voting power of selected shareholders. Neutralizing these impacts is the best way to reconcile the issuance of new shares with the corporation's original business purpose to raise additional equity capital.

Therefore, since the interest of the outsider shareholders to not experience economic dilution is well-established and does not require any further explanation, this Article analyzes the transaction considering either type of dilution that the shareholders may experience. Part III focuses on the opposite side of the transaction and describes the different incentives that managers may carry in abusing their broad power of strategic issuances.

III. THE INCENTIVES OF THE MANAGERS

Opportunistic behaviors may influence managers' decisions to approve a new equity issuance. A seminal study indicated how this is a powerful tool to bypass shareholders' will through the dilution of their voting power and perpetuate the interests of the managers: indeed, from their perspective, the transaction may prove to be a useful tool to "build empires, entrench managers, and dilute shareholder influence."[104]

Arguably, the self-interest that managers might prioritize through equity issuances belongs to the broader class of agency issues in public companies.[105] While articles dating back to the end of the twentieth century assumed that in the specific context of equity issuances managers act in the best interest of the existing shareholders,[106] a recent finding suggests that

102. *See* Lund, *The Case Against Passive Shareholder Voting*, *supra* note 78, at 494–95 (including within the list of participants in this market both institutional investors and hedge funds).

103. *See supra* text accompanying notes 41–59.

104. Rock et al., *Fundamental Changes*, *supra* note 37, at 180.

105. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976), *reprinted in* MICHAEL C. JENSEN, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS AND ORGANIZATIONAL FORMS (2000) (exposing the analysis of agency costs).

106. *See, e.g.*, Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information the Investors Do Not Have* ,13 J. FIN. ECON. 187, 188 (1984); Merton H. Miller & Kevin Rock, *Dividend Policy Under*

new share issuances are not exempt from agency tensions and supports the theory with empirical evidence.[107] A previous empirical analysis in the same field already flagged the case of managers seeking to sell new shares to sympathetic investors through private placements with the ultimate purpose of entrenching themselves.[108] Furthermore, the heterogeneity of interests within the shareholders' class should not be undermined in light of the well-established majority-minority conflict in the public firm, which seems to be even stronger in the context of this specific transaction. In order to point out the incentives that might lead managers to approve strategic issuances to affect the shareholders' voting power, it is critical to understand the different agency tensions that possibly arise between the managers and the shareholders. Namely, this Section addresses separately — following the established pattern in corporate governance literature — managers' incentives in public corporations whose control is contested (Section III.A) and those in controlled public corporations (Section III.B).[109]

A. Non-Controlled Corporation

The non-controlled public corporation is the traditional background of agency issues and of conflicts between shareholders and managers.[110] Although there are several cases of equity issuances merely in the best business interests of the corporation, this Section focuses on the incentives possibly underlying strategic transactions that managers enter into to exploit either value or the voting rights of certain shareholders.

First, the competency to issue additional shares is a powerful tool in the takeover context. The most famous strategic issuance in this scenario is the poison pill, a defensive measure against hostile takeovers.[111] Arguing in

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Asymmetric Information, 40 J. FIN. 1031, 1034 (1985).

107. *See* Clifford G. Holderness, *Equity Issuances and Agency Costs: The Telling Story of Shareholder Approval Around the World*, 129 J. FIN. ECON. 415, 433–34 (2018).

108. *See* Michael J. Barclay et al., *Private Placements and Managerial Entrenchment*, 13 J. CORP. FIN. 461, 481 (2007).

109. *See, e.g.*, Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 564 (noting how the governance issues are different between controlled and non-controlled corporations).

110. *See id.* at 589 (framing the allocation of powers and cashflow rights in a dispersed-ownership structure and summarizing the agency concerns that apply to the case since the tiny fraction of residual cash flows assigned to managers "exposes investors to management agency costs, which are curbed by shareholders' control rights; that is, their ability to terminate management"). *See generally* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007) [hereinafter Bebchuk, *The Myth of the Shareholder Franchise*] (arguing that shareholders are prevented from effectively exercising their control powers).

111. Ganor, *The Power to Issue Stock*, *supra* note 25, at 703.

favor of, or against, the poison pill is beyond the scope of this Article and prominent legal scholars have extensively addressed the topic during the last few decades.[112] The bottom line is that through the issuance of new shares, the managers may disregard the will of shareholders and prevent the sale of control of the corporation if they either deem it the best solution to maximize the interests of the corporation or — building on the several studies on agency tensions in public corporations — their own interests.[113] Along the same line of reasoning and with similar issues, managers may issue new shares to favor the sale of control of the firm and avoid shareholder opposition. The suitable tool would be the top-up option and, again, the ultimate purpose might (although obviously does not have to) be to extract personal benefit from the sale.[114] In addition, future new shares have been massively used in the context of merger and acquisition deals as a side agreement to lock the transaction. Namely, extensive research on deal protections illustrates that in recent public acquisitions, the acquirer has often granted the target a loan that is convertible into common shares in the event that the target's board eventually decides to pursue another (more rewarding) opportunity in the period between the announcement and the closing of the deal, the so-called market canvass.[115]

Second, managers may find that equity issuances are a powerful tool to dilute shareholders even in a non-control-acquisition context. Any shareholder eventually interested in taking part in a serious and effective

112. Among the multiple studies on the poison pill, see Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 904–07 (2002), for a description of the poison pill and endorsing a takeover-oriented position, Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 733–34 (2007), and Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1735–36 (2006), which advocates in favor of the poison pill. *See also* Goshen & Hannes, *The Death of Corporate Law*, *supra* note 79, at 266–69, 277–80 (carrying out an extensive review of the historical evolution of the case law related to the poison pill).

113. *See* Alan K. Koh et al., *Land of the Falling "Poison Pill": Understanding Defensive Measures in Japan on Their Own Terms*, 41 U. PA. J. INT'L L. 687, 694–702 (2020) (providing a detailed review of U.S. literature on the topic); Michael Klausner, *The Empirical Revolution in Law: Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1350–52 (2013).

114. *See* Ganor, *The Power to Issue Stock*, *supra* note 25, at 704, 717–20 (defining the top-up option as a call option that the board of directors of the target grants the bidder in the context of a takeover in order to allow the latter to eventually complete a freeze-out short form merger and pointing out the agency issues possibly affecting the transaction).

115. *See* Fernán Restrepo & Guhan Subramanian, *The New Look of Deal Protection*, 69 STAN. L. REV. 1013, 1043–1048 (2017) (noting that in one case, the conversion would have allowed the prospective acquirer to hold 23.8 percent of the fully diluted shares of the target).

engagement activity is a potential threat to the incumbent managers, should her agenda not overlap with management's business plan. As already mentioned, the legal literature agrees about the increased sophistication of shareholders in the current framework of the U.S. public firm.[116] A recent essay described institutional shareholder engagement as a way to influence the long-term strategies of the firm: while the essay pointed out how this attitude differs from the more aggressive and, allegedly, short-termist approach of the activist hedge funds, it also indicated engaged shareholders' expectations concerning the board's accountability and the firm's accomplishment of their goals.[117] In addition, Professor Coates recently argued that index fund managers — because of the indexation of ownership, which has determined a rise in shareholders' powers — now exercise a strong pressure to influence the managers of a wide range of public corporations.[118] Professor Coates's research indicated that there was increased engagement of shareholders who connect with the board of directors in order to disclose their policies and share their feelings about managers and corporate activity.[119] BlackRock itself, an investment management corporation that has publicly committed to a model of shareholders' engagement based on an enhanced interaction with the board for a few years,[120] warned that if the expectations and the ideas that the BlackRock Investment Stewardship team shared in the context of engagement activity were not fulfilled, the team would not hesitate to vote against management's recommendations as a last resort tool.[121] Not only do

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116. *See supra* text accompanying notes 78–91.

117. *See* Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuck-Strine Debate*, 12 N.Y.U. J.L. & BUS. 385, 392 (2016).

118. Coates, *supra* note 88, at 19 ("The bottom line of this influence is very different than what the term 'passive' investment implies. Rather than blindly choosing stocks in their index and then ignoring them, index fund managers have and are increasingly using multiple channels to influence public companies of all sizes and kinds. Their views on governance issues, their opinions of CEOs, their desires for change at particular companies, their response and evaluations of restructuring or recapitalization proposals from hedge fund activists — all of these matter intensely to the way the core institutions in the U.S. economy are operating."); *see also* Marcel Kahan & Edward Rock, *Anti-Activist Poison Pills*, 99 B.U. L. REV. 915, 940 (2019) [hereinafter Kahan & Rock, *Anti-Activist Poison Pills*] ("[O]ver the last two decades, as the trend towards increasing institutionalization of shareholding has continued, the largest institutions have awakened to their power.").

119. *See* Coates, *supra* note 88, at 16; Rock, *Institutional Investors in Corporate Governance*, *supra* note 78, at 381 ("[I]nstitutional investors are engaging with management in a much more active way than ever before.").

120. *See, e.g.*, *BlackRock: Ebb and Flow*, FIN. TIMES (Apr. 12, 2018), https://www.ft.com/content/ee2cd1d6-3e6e-11e8-b9f9-de94fa33a81e.

121. *See* BLACKROCK, THE INVESTMENT STEWARDSHIP ECOSYSTEM 7 (2018), https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-steward

these findings corroborate the argument that shareholders carry an interest in avoiding dilution of their voting rights but also — and more importantly for the purpose of this paragraph — this attitude is likely to make management subject to duties of accountability and responsiveness towards sophisticated shareholders, undermining its autonomy and possibly increasing its incentive to approve dilutive equity issuances. Should the incumbent managers be or feel threatened that such engaging shareholders support different management in the medium/long-term, the incentive is amplified. On that point, authoritative scholars have recently explained that the enhanced powers of institutional investors in public firms' governance have weakened the position of managers who increasingly value any tool that empowers them to affect the corporation's ownership structure to insulate themselves.[122] The larger the stake the institutional investors have, the more likely they are to have the power to replace the board of directors.[123] The case is further corroborated by the argument that when institutional investors engage with the management of a company, the latter is aware that should an activist campaign start in the future, the institutional investors have a critical role in determining its outcome, and are likely to base their votes on whether the firm had fulfilled the shareholders' agenda.[124]

Many prominent practitioners and legal scholars have claimed that shareholders with long-term targets are beneficial to the firm.[125] From an

ship-ecosystem-july-2018.pdf (corroborating the report in some cases when BlackRock effectively voted against management's recommendation). Note that in all the instances where BlackRock voted on a proposal against management's recommendation, such proposal was approved with a majority below seventy percent. *See id.* at 9. Therefore, even a tiny dilution of the voting power might have fulfilled an assumed goal of the managers to entrench themselves.

122. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 992 (applying the reasoning — in order to explain the creation of dual class structures — to the case of the controller-manager fearing that she might fail to pursue her idiosyncratic vision).

123. *See* Hamdani & Hannes, *The Future of Shareholder Activism*, *supra* note 79, at 983 ("[C]orporate managers might become the ones that cannot risk their relationship with the mutual funds complex, especially when all funds of the same fund family tend to vote together.").

124. *See* Coates, *supra* note 88, at 17; *see also* Gilson & Gordon, *supra* note 80, at 896 (pointing to the pivotal role of institutional investors in activist campaigns and, more broadly, the necessary interaction of activists and institutional investors in the current ownership structure of public firms).

125. *See, e.g.*, Martin Lipton, *It's Time to Adopt the New Paradigm*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 11, 2019), https://corpgov.law.harvard.edu/2019/02/11/its-time-to-adopt-the-new-paradigm/ (encouraging a proactive dialogue between the firms and their long-term shareholders, who should also share their concerns and expectations about the corporation, and arguing that the engagement between the parties should also be sought before the submission of a shareholder's proposal); Mallow & Sethi, *supra*

ex-ante perspective, the risk of such dilution is likely to discourage shareholder engagement. Among the different views of corporate governance involvement that institutional investors have and should have, a consensus developed over the significant investment of time, money, and skills that engaged governance requires for a specific corporation.[126] The risk to be unduly diluted, should such effort result in an engagement not complying with management's plans, is not attractive. The argument is even more applicable to any shareholder with a long-term view, given that she has no certainty that in the future she will be able to keep her fractional voting power in the event of a disagreement with management. In addition, from an *ex-post* perspective, the effort of such engagement activities would be pointless not only for the specific shareholder but for the corporation itself. Namely, if the agenda of the engaged shareholder overlaps with management's expectations, the utility of the effort is marginal; by contrast, should the activity result in a disagreement with the managers, the latter might dilute the shareholder with no benefit for the corporation. In an oversimplified way, the extreme scenario is that the board decides to "fire" the shareholders through a dilutive issuance.

A similar reasoning applies, and its impact amplifies, if an activist shareholder is in the ownership structure of the corporation.[127] In such a context, the incentives of the managers to dilute the incoming activist are increased and reach their peak when the activist is reasonably confident of success in a prospective proxy fight due to the support of some institutional investors.[128] Authoritative legal scholars have pointed out the importance of a relationship between institutional shareholders and activist hedge funds: while the activist hedge fund acts as the voice of the institutional shareholders, the institutional shareholders are passive with regard to the

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note 117, at 389–90 (providing a detailed definition of engagement); Rock, *Institutional Investors in Corporate Governance*, *supra* note 78, at 371 (describing the efforts of legal scholars and regulators aimed at addressing the lack of adequate shareholder engagement).

126. According to many prominent scholars, the need for extensive resources prevents many institutional investors from being more actively involved or effectively involved, depending on the voices, in the corporate governance of the firms in which they participate. *See* Gilson & Gordon, *supra* note 80, at 872–73; Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2043–75 (2019) [Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*] (developing an extensive analysis of the costs incurred by index funds).

127. *See, e.g.*, Rock, *Institutional Investors in Corporate Governance*, *supra* note 78, at 382 (exposing the differences between hedge funds and "traditional" institutional investors).

128. *See supra* text accompanying notes 78–91 (describing the institutionalization of the shareholder base of public firms).

corporate governance proposals but keener on exercising their voting rights over the activist hedge fund.[129] The hedge fund's activist campaign may originate from the dissatisfaction of institutional investors due to the failure of management to address their priorities.[130] In such a scenario, if the managers fear defeat in the campaign, they might decide to dilute the hedge funds' shares, and the shareholders will be expected to support its campaign through a material share issuance. Based on the usual business pattern of the activists — which need to collect voting shares in order to claim corporate changes that reward their initial investment[131] — a decline in the voting power negatively affects the activist's odds of success. Managers may use poison pills with lower thresholds as a weapon against the activist hedge fund.[132] Both *Yucaipa American Alliance Fund II, L.P. v. Riggio*[133] and *Third Point LLC v. Ruprecht*[134] witnessed the adoption of a shareholders' rights plan triggered at thresholds significantly below the majority control — respectively twenty percent and ten percent — and tailored[135] against the activist possibly seeking to target the issuer with a proxy contest. In both cases, the courts evaluated the threats posed by the activist and the proportionality of the reaction and emphasized the risk of an underpriced acquisition of a controlling issuer.[136] Even if shareholders' rights plans are

129. *See* Gilson & Gordon, *supra* note 80, at 866–67; Lund, *The Case Against Passive Shareholder Voting*, *supra* note 78, at 505 (pointing out that the consensus-seeking hedge funds, in order to increase their odds of success in their campaign, often tailor their agenda to the institutional shareholders' priorities); Rock, *Institutional Investors in Corporate Governance*, *supra* note 78, at 381 (exposing the change in the behavior of institutional investors, who are now willing to support value-enhancing intervention by the hedge funds rather than deferring to managers); Kahan & Rock, *Anti-Activist Poison Pills*, *supra* note 118, at 940 (flagging that institutional investor support is an indispensable condition for the activists' success).

130. Hamdani & Hannes, *The Future of Shareholder Activism*, *supra* note 79, at 988.

131. *See* Lund, *Nonvoting Shares*, *supra* note 59, at 695.

132. *See* Kahan & Rock, *Anti-Activist Poison Pills*, *supra* note 118, at 935; *see also* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1069 (2007) [hereinafter Kahan & Rock, *Hedge Funds in Corporate Governance and Corporate Control*].

133. 1 A.3d 310 (Del. Ch. 2010).

134. No. 9469-VCP, 2014 WL 1922029 (Del. Ch. May 2, 2014).

135. *See id.* at *20 (explaining the two-tiered structure of the pill, which was triggered at a lower threshold if the purchaser sought to influence the control of the issuer); *Yucaipa*, 1 A.3d at 321 (granting an exemption to the company's founder, whose beneficial ownership was above the threshold triggering the pill).

136. *See Third Point*, 2014 WL 1922029, at *17 ("I cannot conclude that there is a reasonable probability that the Board did not make an objectively reasonable determination that Third Point posed a threat of forming a control block for Sotheby's with other hedge funds without paying a control premium."); *Yucaipa*, 1 A.3d at 331 ("[T]he board's motivation was to protect Barnes & Noble from the threat of being

not technically traditional issuances of new shares (in the form of rights offering), their effects are substantially similar in that, rather than diluting a shareholder, shareholders' rights plans prevent a shareholder from increasing her voting power by threatening a dilution. To this extent, it has been pointed out how the power to issue shares is often undermined in any discussion concerning poison pills, in spite of being a critical part of it.[137] Although these plans are unlikely to be held as primarily aimed at interfering with the shareholders' franchise,[138] their impact on the shareholders' powers is material. Note that in *Third Point v. Ruprecht*, other institutional shareholders joined the hedge fund as plaintiffs, corroborating the theory that at least some shareholders deem it critical to have a voice on these issues.[139]

Since this Article concerns corporations with publicly traded shares, the immediate objection to this point seems that the "activists' team" could easily increase its stake and restore its pre-issuance voting power on the market. Therefore, the equity issuance would prove to be ineffective. However, Professors Gordon and Gilson's analysis illustrates the flaw of this response.[140] To begin with, activist hedge funds seek an economic reward from the increase in the issuer's share price after their intervention.[141] Empirical analysis found that as soon as an activist hedge fund discloses to the public its purchase of a stake in a listed corporation, the trading price of the issuer's shares increases because the market moves forward and incorporates a significant part of the purported beneficial effects of the activist campaign into the short-term trading price.[142] Therefore, it is critical for hedge funds to be able to purchase a reasonably large stake ahead of the trigger of the mandatory disclosure obligation.[143] If the firm issues new equity after the activist's disclosure, the price of the new shares issuance is

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subject to inordinate influence or even control by a bloc that emerged without paying a fair price for that control. The effect on electoral rights was an incident to that end.").

137. *See* Ganor, *The Power to Issue Stock*, *supra* note 25, at 703.

138. *See Third Point*, 2014 WL 1922029, at *16, *18.

139. *Id.* at *1 ("The other plaintiffs in this litigation are institutional stockholders who purport to represent the interests of the corporation's stockholders other than the hedge funds.").

140. *See* Gilson & Gordon, *supra* note 80, at 902–06 (explaining the business model of the activist investors).

141. *See, e.g.*, Kahan & Rock, *Anti-Activist Poison Pills*, *supra* note 118, at 920, 923–24 (providing a detailed analysis of the business model of activist hedge funds and a description of their concern in avoiding either type of dilution).

142. Gilson & Gordon, *supra* note 80, at 903 n.138, 903–05.

143. *See id.* at 904 (using the argument to challenge a proposed securities regulation aimed at amending the disclosure obligation rule, both broadening its scope of applicability and shortening the time for the investor to comply with the disclosure obligation).

likely to reflect such increase in the stock's trading price.[144] It is therefore an obvious remark that, should the activist be willing to purchase on the market, it purchases the shares at the new increased price, increasing the overall average price per share of its stake. In other words, the activist's goal to secure a large position before filing the disclosure would be frustrated. The described scenario undermines the investor's action, forcing her to either purchase additional shares at the increased price after the disclosure or, reasonably, give up on her campaign.

In addition, since the activists are usually risk-averse and allocate a set amount of funding, incurring an additional purchase is problematic even absent an increase in the price per share.[145] The argument that hedge funds typically tend to avoid putting "too many eggs . . . in one investment basket" supports that statement since an additional investment becomes necessary to retain the significant minority shareholding that they need in order to be effective when approaching the management of the corporation.[146] This argument on one side corroborates the case that hedge funds carry an interest in not having their voting power diluted and, on the other, undermines their potential willingness to increase their economic investment to retain their fractional stake in the post-issuance ownership structure. Note that, since in the scenario that this Section addresses, the purpose of the strategic transaction is to generally dilute a specific shareholder or a block of them, the managers do not need to issue shares to a specific investor, a so-called "white squire."[147] Arguably, although the case of an equity issuance in favor of sympathetic (with management) investors further strengthens the position of the latter, even an issuance to investors in the general public is likely to be effective in lowering the chances and increasing the costs of the to-be-diluted shareholder's ability to keep a significant stake and be successful in its campaign. This feature not only avoids the difficulty of searching for a white squire willing to incur a significant investment but also makes an

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144. *Id.* at 903 (discussing how the price of the shares increases once an activist discloses its purchase of stocks in a certain target).

145. *See id.* at 909–10.

146. Cheffins, *supra* note 67, at 487 (using the argument in order to explain the relatively small presence of hedge funds in very large public firms and suggesting the reason is they would need an excessive investment in a single company in order to "buy up a minority stake sufficiently sizeable to capture management's attention and to yield meaningful profits in the event of success").

147. The white squire is a tool used by managers who, seeking to secure their entrenchment, selectively issue a block of shares to a sympathetic investor willing to support them. *See* Ganor, *The Power to Issue Stock*, *supra* note 25, at 731–32; Paul Davies et al., *Control Transactions*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 205, 214 (3d. 2017) (explaining the white squire's action, also called "white knight").

important argument in order to avoid the requirement of the shareholders' approval that stock exchange rules set forth in the event of highly dilutive equity issuances.[148]

In addition, the threat of such a dilutive issuance might be effective not only in frustrating the result of an activist's campaign but also, from an ex-ante perspective, in discouraging their intervention at all. This Section does not intend to take a position in favor of, or against, shareholder activism or shareholder engagement.[149] Contrarily, the purpose is to point out where the incentives of managers to use the equity issuances to affect the ownership structure of a dispersed public corporation lie and how such corporate transactions are an effective and powerful means to achieve goals other than the raising of funds for the corporation.

Finally, an equity issuance in a public firm whose control is contested is a powerful tool regardless of the considerations on shareholder activism and engagement. The above-mentioned case *Reith v. Lichtenstein*[150] witnessed the acquisition of majority control by a shareholder throughout the years. The 2013 settlement agreement — which enabled Steel Holdings to be issued new shares that, together with the warrants it was granted in the same circumstances, approximately doubled its stake from 14.9 to 29.9 percent — had a strong impact on the ownership structure of the firm.[151]

A last caveat is necessary. This Section did not analyze the hypothesis of the quasi-controller who seeks the support of the board of directors in order to pursue control of the corporation through the equity issuance, although it formally pertains to the scenario of the public corporations whose controller is contested. The next Section addresses this case.[152]

B. Controlled Corporations

Controlled corporations are becoming increasingly important in the U.S. market,[153] which has historically been different from the European one,

148. *See infra* Section IV.B.

149. *See* Lund, *The Case Against Passive Shareholder Voting*, *supra* note 78, at 502–03, 503 n.41 (reviewing the literature on this debate); *see also* Kahan & Rock, *Anti-Activist Poison Pills*, *supra* note 118, at 918 n.6 ("The effects of activism are likely to differ systematically depending on the style of the activist; the type of target; the year the activism took place; and, most importantly, the skills of a particular activist and quality of the business plan it wants to pursue.").

150. No. 2018–0277-MTZ, 2019 WL 2714065 (Del. Ch. June 28, 2019); *see supra* text accompanying notes 1–6.

151. *Reith*, 2019 WL 2714065, at *2, 3.

152. *See infra* Section III.B.i.

153. *See* Da Lin, *Beyond Beholden*, 44 J. CORP. L. 515, 520 (2019) ("According to a 2014 study by the law firm Davis Polk & Wardwell LLP, 54 of the 100 largest initial public offerings between September 2011 and October 2013 were of companies with one

where the percentage of controlled listed firms has always been large. The definition of controlling shareholder encompasses not only (i) a shareholder who owns more than fifty percent of the voting power of the corporation (*i.e.*, the so-called de jure control) but also (ii) a shareholder who owns less than fifty percent of the voting power of the corporation but exercises control "over the business affairs" of the corporation (*i.e.*, the so-called de facto control).[154] While the concept of control over the business affairs of the corporation has subsequently been refined and transposed to control over the directors,[155] the fractional voting power that a shareholder should retain in order to qualify as a controller is still unclear.[156] The class of controlled corporations covers the cases of both concentrated ownership[157] and dual-class structure: although this Article generally tends to consider the position of the controlling shareholder regardless of the proportion between the percentages of, respectively, the voting rights and the financial rights she holds, this Article will occasionally distinguish between the two situations.

Generally, the presence of a controller in the ownership structure of the

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shareholder holding more than 50% of the voting power. As of 2015, seven percent of companies in the S&P 1500 index have one shareholder or group holding more than 30% of the company's voting shares."); Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 594–95 (2017) [hereinafter Bebchuk & Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*] (reporting, among other things, that as of July 2016, dual-class controlled companies in the U.S. economy had "an aggregate market capitalization exceeding $3 trillion"); Jesse M. Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 79, 79 (Luca Enriques & Tobias H. Troger eds., 2019) [hereinafter Fried, *Powering Preemptive Rights with Presubscription Disclosure*].

154. Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1113–14 (Del. 1994) (citing Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987)); *see Reith*, 2019 WL 2714065, at *21–23 (carrying out an analysis of the minority controlling status); Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 953 ("Control rights are, broadly stated, rights to decide on the business direction of a company, ranging from day-to-day operational to strategic management decisions.").

155. *See In re* Tesla Motors, Inc. S'holder Litig., No. 12711-VCS, 2018 WL 1560293, at *12–13 (Del. Ch. Mar. 28, 2018) (reviewing the case law and applying the criterion).

156. *See* Goshen & Hamdani, *Majority Control and Minority Protection*, *supra* note 21, at 449, 449 n.1 ("In the United States, Delaware Courts have declined to quantify the precise percentage of stock necessary to constitute an 'effective majority' [of the voting rights], choosing instead to engage in a factual inquiry of the exercise of actual control in each case."); *see also* Ann M. Lipton, *After* Corwin*: Down the Controlling Shareholder Rabbit Hole*, 72 VAND. L. REV. 1977, 1990 (2019) (carrying out an analysis of the most recent case law and noting that "no particular level of voting power is determinative" to assess the control status).

157. *See* Goshen & Hamdani, *Majority Control and Minority Protection*, *supra* note 21, at 449 (providing a definition of concentrated ownership structure as the firms where the controller "holds an effective majority of the firm's voting and equity rights" and therefore flagging a material difference with the case of dual-class firms).

firm has a sizeable impact on the corporation's decisions.[158] This makes the statement that the main goal of corporate law in controlled corporations is to protect minority shareholders largely shared and relatively undisputed.[159] Controlling shareholders are generally subject to fiduciary duties as much as the board of directors: transactions involving controlled companies trigger the entire fairness standard if they are deemed to be conflicted, *i.e.*, the controller stands on both sides of the transaction and gets a "unique benefit" from it.[160] However, focusing on the issuance of new shares, it seems reasonable to value the shareholder's influence over the decision maker (*i.e.,* the board of directors) with regard to the specific transaction. The ultimate distinction is between the cases of: (i) the controller purchasing the newly issued shares; and (ii) the controller not participating in the issuance. In fact, the distinction determines whether the case falls in, respectively, the majority-minority or the director-shareholder conflict. Notwithstanding the different labels, it is critical to understand *who* the outsider shareholders that the managers may seek to dilute are (*i.e.*, whether the controller or the minority shareholders) and who, if anyone, the managers have incentives to favor. Arguably, since management is empowered to approve the issuance, corporate law should broadly protect the shareholders who are not related to the decision maker and whose stakes may incur a dilution because of the issuance.

This Section aims to point out some of the possible incentives that may lead the managers of a controlled corporation to use the issuance of new equity as a tool to exploit either the financial or economic rights of the outsider shareholders. Namely, this study covers both underpriced and non-underpriced issuances, claiming that even the latter may prove to be a powerful tool for the managers to perpetuate self-interests.[161] Section III.B.i

158. There is an extensive debate in the literature concerning whether the presence of a controller is beneficial or detrimental to the corporation, especially in the case of dual-class structure. *See, e.g.*, Bebchuk & Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, *supra* note 153, at 596–99, 609–13 (extensively exposing the policy debate on the topic and claiming that the potential benefits of the structure decline throughout the years); Young Ran (Christine) Kim & Geeyoung Min, *Insulation by Separation: When Dual-Class Stock Met Corporate Spin-Offs*, 10 U.C. IRVINE L. REV. 1, 27–28 (2019) (reviewing the literature debate on the upsides and downsides of the dual-class structures).

159. *See, e.g.*, Jesse M. Fried et al., *The Effect of Minority Veto Rights on Controller Pay Tunneling*, 138 J. FIN. ECON. 777, 778 (2020) [hereinafter Fried et al., *The Effect of Minority Veto Rights*] ("[A] key governance objective is protecting minority shareholders from tunneling by the controller.").

160. *See, e.g.*, IRA Tr. FBO Bobbie Ahmed v. Crane, No. 12742-CB, 2017 WL 7053964, at *6 (Del. Ch. Dec. 11, 2017).

161. However, when proposing the adoption of a new rule, the policy approaches in the case of firms having concentrated ownership or a dual-class structure may be slightly

analyzes the more customary case of the controller purchasing shares, resulting in a potential harm to minority shareholders, while Section III.B.ii addresses the case of the controller not subscribing the new shares.

i. The Purchasing Controller

The case of this Section is that the controller purchases more than her ratable part of the newly issued shares and therefore increases her fractional stake in the firm. To this extent, she should be allocated to the category of the firm's managers, and the involved agency tension presumably opposes the controller-manager to the outside minority shareholders. Also, the incentives of the managers in using the equity issuance to perpetrate abuses are significantly different: in the analyzed hypothesis of the non-controlled corporation, the managers were assumed to have the goal to entrench themselves, build empires or, more broadly, retain their independence and lack of accountability to shareholders. While the purpose of building empires would still be valuable for the controller-manager,[162] this case carries a material difference since the board of directors is already under the influence of the controlling shareholder and it acts in conjunction with her in the customary majority-minority conflict.[163] The controller-manager may seek economic benefits as, respectively, a direct or indirect consequence of the transaction, depending on the issuance price. This leads to the analysis of two different scenarios, both of which involve the exploitation of value from minority shareholders that the legal scholarship addresses as "tunneling."[164]

a. Cheap-Issuance Tunneling

The immediate way to shift value from minority shareholders to the controller is achieved through the issuance of shares to the latter in exchange for a low price, the so-called "cheap stock tunneling."[165] The case is very

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different.

162. *See* Sang Yop Kang, *Re-Envisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Often Embrace*, 16 U. PA. J. BUS. L. 843, 869–70 (2014) (indicating both pecuniary and non-pecuniary benefits of empire building from the perspective of the controller).

163. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 355 (assuming management is under the influence of the controllers and seeks to enhance their interests against those of the other investors).

164. *See* Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 571 n.32 ("The term tunneling refers to transactions, especially within a business group or a pyramidal ownership structure, on terms aimed at favoring the controlling shareholder."). *See generally* Vladimir A. Atanasov et al., *Law and Tunneling*, 37 J. CORP. L. 1 (2011) (providing for an extensive review and taxonomy of the tunneling).

165. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra*

straightforward since the transaction provides the controller with a direct economic gain. She is enabled to increase her financial and voting rights in the firm, in exchange for a price per share below its market value. The harmed parties are those who fail to participate (at least) pro-rata in the issuance and are therefore diluted from both economic and voting right perspectives. Arguably, the structure of the deal of *Corwin v. British American Tobacco* meets these features.[166] Namely, there is a reasonable ground to claim that the issuance was cheap, given the virtual $920 million profit that the purchaser was able to secure at the time of closing. Furthermore, the express ruling of the Supreme Court of North Carolina — relying on Delaware case law[167] — that the subscriber was not a controlling shareholder, does not exempt the case from being considered a cheap issuance in a controlled company for the purpose of this analysis. In fact, although the study of the standards to be met in order to be considered a de facto controller is beyond the purpose of this Article,[168] it seems worth noting that the purchaser was a forty-two percent shareholder, with a significant influence over the board,[169] and did not share the profit with the outsider public shareholders — whose shares were the only ones that the issuance diluted. To this extent, the ruling corroborates the claim that the outsiders lack adequate instruments to avoid exploitation of value and voting rights from the most powerful shareholder of the firm.

b. Non-Cheap Issuance

The second scenario is met when the actual goal of the controller is to obtain non-direct benefits from the transaction, which are not (or not entirely) shared with the minority shareholders. The feature of the transaction, therefore, is that the issuance price does not have to be unfair or, in a more sophisticated way, is not below the market value of the firm's shares. Professors Fried and Spamann pointed out the case of a controller seeking to dilute minority shareholders in order to strengthen her voting power and cross a specific voting threshold, which, for example, is required to approve certain transactions.[170] In such a scenario, the issuance price

note 95, at 353; Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 81–83 (describing cheap-issuance tunneling as a transaction that dilutes the minority shareholders who do not purchase their ratable portions of the new equity in that the overall equity value of the firm is not sufficiently increased to offset the loss in their fractional equity ownership).

166. *See supra* text accompanying notes 7–9.

167. Corwin v. Brit. Am. Tobacco, 821 S.E.2d 729, 737–39, 743 (N.C. 2018).

168. *See supra* text accompanying notes 153–57.

169. *See Corwin*, 821 S.E.2d at 753–54 (Hudson, J., dissenting).

170. Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra*

might include a premium over the market value, provided that the benefits that the controller obtains from the transaction are higher than the price she is paying to purchase the shares: the shares would not be *absolutely* cheap but would be *relatively* cheap from the controller's perspective[171] since the transaction enables her to capture indirect economic benefits. Reasonably, this situation occurred in *Reith v. Lichtenstein* since in 2017, the alleged controlling shareholder strengthened its stake through an issuance of convertible preferred shares whose conversion price was at a 31.5 percent premium over the closing price of the traded stocks on the day before the closing of the transaction.[172] Notably, as a result of this issuance — coupled with the equity grants to three directors affiliated with the same shareholder — the purchaser was able to cross the line of majority control of the firm, achieving a 52.3 percent stake.[173]

The same above-mentioned research addresses when the controller's benefits concern the use of the proceeds of the issuances (*e.g.*, the new equity is used to enter into an overpriced purchase from the controller).[174] The use of the proceeds of issuances is even more troublesome since it requires neither a cheap issuance price nor the voting dilution of the minority shareholders. However, for the purpose of this Article, it seems reasonable to argue that the damage to the minority shareholders is not directly perpetrated through equity issuances but rather through the use of proceeds in the subsequent — although connected — purchase from the controller.[175]

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note 95, at 362–63 (emphasizing the importance of voting rights in analyzing equity issuances). Notably, the statement was not tailored to public corporations but seems applicable in such a context too.

171. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 100 (introducing the concept of price-relativity in the context of new share issuances in the case of securities that could be overpriced but still "*effectively* cheap" for the controller).

172. Reith v. Lichtenstein, No. 2018–0277-MTZ, 2019 WL 2714065, *4 (Del. Ch. June 28, 2019).

173. *Id.* at *5.

174. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 357–58.

175. Professors Fried and Spamann studied the issuance of cheap stocks from the perspective of the asymmetric information issue in the context of the right offer. *See id.* Therefore, the controller's information about the use of proceeds (which in the considered hypothesis was at her advantage) might effectively lead her to relatively appreciate the shares in a different way compared to general public shareholders. *See id.* at 357. Contrarily, the purpose here is to show how the managers of a public corporation might damage minority shareholders with an equity issuance. In the example at hand, unless the two transactions (issuance and use of proceeds in a related party purchase of goods or securities) are considered as a whole, the position of this Article is that the issuance by itself does not damage the minority shareholders.

The non-underpriced issuance becomes more hybrid should the purchaser be a quasi-controller — *i.e.*, dominating but not controlling the firm[176] — who seeks to acquire control of the firm. In such a case, the quasi-controller can extract massive benefits from the transaction[177] and therefore is willing to pay a material premium over the market shares.[178] A corporate transaction that Delaware courts scrutinized in 2014 witnessed this situation.[179] Although the control of the corporation was contestable, the combination of the securities, contractual rights, board representation, and relationships with management that the shareholder Yucaipa American Alliance Fund II, L.P. ("Yucaipa") carried made Yucaipa a quasi-controller of Morgans, a Nasdaq listed corporation.[180] Among other things, Yucaipa held the majority of the senior subordinated notes of the company — convertible in common stocks starting from three months before their due date — as well as 100 percent of the preferred stocks and warrants to purchase a non-trivial amount of public stocks; furthermore, it had invasive veto rights on several extraordinary transactions and was entitled to appoint one member of the board.[181] The transaction was structured as a rights offering issuance at a price that provided an unusual twenty-six percent premium over the then-current

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176. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 94–95 (providing as an example of a quasi-controller, the thirty percent shareholder of a corporation whose second-largest shareholder has a twenty percent stake). The notion of quasi-controller may belong to the same family as that of "effective negative control," which the Delaware Court of Chancery framed as a case of shareholders exercising "disproportionate control and influence over major corporate decisions, even if they do not have an explicit veto power." Third Point LLC v. Ruprecht, No. 9469-VCP, 2014 WL 1922029, at *21 (Del. Ch. May 2, 2014).

177. *See* Xueping Wu et al., *A Rent-Protection Explanation for SEO Flotation-Method Choice*, 51 J. FIN. & QUANTITATIVE ANALYSIS 1039, 1040 (2016) (providing a recent literature review of the studies concerning the private benefits of control); *see also* Kahan & Rock, *Anti-Activist Poison Pills*, *supra* note 118, at 937–38 ("Unlike positive control — which enables the investor who wields it to elect a board to its liking or cash out minority shareholders and consequently justify special concerns about control under Delaware law — negative control merely enables the wielder to block a limited set of transactions that the board proposes.").

178. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 95 (addressing the issue in the context of right offerings and explaining how a quasi-controller in order to achieve control "may use an offer price that is clearly high (or at least appears high) to deter other investors, including any potential rival, from participating"). Reasonably, the same argument also applies to the case of the quasi-controller increasing her fractional voting power in a non-right-offering issuance.

179. *See* OTK Assocs., LLC v. Friedman, 85 A.3d 696, 704 (Del. Ch. 2014).

180. *Id.* at 724; *cf.* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 95 n.60 (mentioning the transaction as an example of an overpriced issuance aimed at enabling the quasi-controller to gain control of the issuer through a more-than-pro-rata subscription of the new shares).

181. *OTK*, 85 A.3d at 704.

market price of shares.[182] While the structure of the equity issuance as a rights issue rather than as a cash offer[183] is not critical in this Section, what matters is that management allegedly acted in conjunction with Yucaipa to maximize the latter's odds to pursue the issuer's control. Namely, based on its financial advisor's forecasts, Yucaipa was expected to reach a fraction equal to thirty-five percent of the common stocks issued after the transaction.[184] Yucaipa sought to gain control of the corporation — at the time challenged by another significant shareholder who subsequently was the claimant in the Delaware dispute — through an overpriced issuance aimed at discouraging many public shareholders from the subscription.[185] However, in the context of the fight, Hyatt offered to buy all the shares of Morgans, in exchange for a higher price (*i.e.*, \$7.50 per share against \$6.00), but the managers of the issuer ignored the proposal and avoided its disclosure.[186]

Even if the control of the corporation is formally contested before the equity issuance, this Article treats this transaction as if it were a controlling shareholder's subscription in light of the dominant position that a quasi-controller may exercise within the firm. The influence she is able to exert over management — sympathetic with her goal to acquire control — further confirms this intuition. Also, in terms of the possible damages that the shareholders non-related to the quasi-controller may suffer because of the transaction — and of the protection that a legal system needs to set forth — the issuance proves to be close to the case of the purchasing-controller, witnessing the board acting in conjunction with her. In fact, in both cases, the firm's ownership structure after the transaction provides for a controller that has diluted the other shareholders' shares through a strategic and selective equity issuance approved by the board. Although the merit of legal protections will be discussed later in this Article, in the mentioned case, *OTK v. Friedman*, the court itself analogized Yucaipa's influence to that exercised by a controller: namely, "for purposes of the motion to dismiss, Yucaipa is deemed to control Morgans."[187] The transaction was deemed to confer "a unique benefit on a party exercising de facto control."[188]

182. *Id.* at 707.

183. *See* Wu et al., *supra* note 177, at 1039 (describing the most common floatation methods in seasoned equity offerings and their respective features).

184. *OTK*, 85 A.3d at 707.

185. *See id.*

186. *Id.* at 709.

187. *Id.* at 724.

188. *Id.* Note that depending on the definition of quasi-controller that is adopted, even *Reith v. Lichtenstein* might seem to fall in this category as well as most of the cases of minority controlling shareholders. However, the court expressly affirmed that Steel

As a final remark, both controllers and quasi-controllers may have an increased incentive in strengthening their position in the firm through a non-underpriced (or an overpriced) issuance, in the event of an activist's action. As a dedicated research study explained, there are a non-trivial quantity of cases of controlled companies that are subject to activist intervention.[189] Although companies whose control is completely uncontested are not fully insulated, the risk is even more material for de facto *controllers* — since the activist may challenge them in a proxy fight[190] — and, of course, for quasi-controllers.

As Part II pointed out,[191] the current legal framework fails to protect shareholders should the firm issue shares in exchange for a price that Delaware courts deem "objectively" fair. This Section explained the managers' incentives and how they — acting in conjunction with the controlling shareholders — may take advantage of this flaw to exploit the minority shareholders. The following Section addresses the same flaw from the perspective of managers who have the opposite goal of diluting the controller.

ii. The Non-Purchasing Controller

The last case that this Article considers is the controller who does not purchase the newly issued shares: the hypothesis in which the controller decides to refrain from the subscription of the new shares for any reason, including that she is seeking to exploit the minority shareholders or other investors issuing overpriced shares (*i.e.*, overpriced-issuance tunneling),[192] but this is beyond the purpose of this Section since there is no harm to

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Holdings was a controlling shareholder before the transaction and, more importantly, this Article considers controllers and quasi-controllers in the same group. Reith v. Lichtenstein, No. 2018-0277-MTZ, 2019 WL 2714065, at *10 (Del. Ch. June 28, 2019) ("[E]ven if control is analyzed as of December 2017, when the board approved the Challenged Transactions, it is reasonably conceivable that Steel Holdings was a controlling stockholder, and that it exercised actual control over the Company for purposes of the IWCO acquisition.").

189. *See* Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. BUS. L. REV. 60, 124–25 (2016); Lund, *Nonvoting Shares*, *supra* note 59, at 741–44 (recommending a prohibition of only issuing the public non-voting stocks because, otherwise, a firm may be able to ignore any external pressure).

190. *See* Kastiel, *supra* note 189, at 95 ("Activists may also threaten to challenge an 'effective' controller, who owns less than 50% of the voting power, by seeking board representation despite the low ex ante chances of winning a proxy fight against an effective controller.").

191. *See supra* Section II.B.

192. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 356–58 (discussing extensively the advantages of controllers over minority shareholders).

outsider shareholders in their capacity as existing shareholders but only in their capacity as new investors should they purchase the new shares. Contrarily, this Section focuses on the scenario in which management seeks the dilution of the controller in the context of the shareholder-managers conflict. To this extent, in this Section, the controlling shareholder is not considered within the category of the firm's managers since, at least in the specific transaction, she is an outsider (as is proved by the fact that the board of directors can approve a dilutive issuance against her will).

Given that the controlling shareholder is presumptively not willing to lose her status within the firm and part (or all) of the private benefits that result from it,[193] and that she is supposed to exercise control over the board, such a transaction might seem extremely unlikely to occur. Indeed, several studies on the point either implicitly or explicitly[194] assume that the incumbent controller retains a non-trivial role in the decision concerning the issuance of new equity and therefore often analyzes such transaction from the perspective of the controller who is seeking to structure the issuance in her best interests.[195] The assumption is well-grounded in the Delaware legal framework where "the controller always has such power if she controls the board and a majority of the shareholder votes, but board control by itself often suffices."[196] However, the recent *CBS v. NAI*[197] case witnessed a shareholder having a majority of the voting power, but not effective control over the managers, which proved to be non-deferential at least for the purpose of the equity issuance, and entered into a firm reorganization aimed at exacerbating the controller's influence. [198]

In this and similar contexts, the best interests of the corporation might inspire management's action: Delaware case law explicitly acknowledges the power of the board of directors to dilute a shareholder should she represent a serious threat to the corporation.[199] However, although the

193. *See* Wu et al., *supra* note 177, at 1057.

194. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 355.

195. *See* Wu et al., *supra* note 177, at 1049 ("[I]f the incumbent chooses a cash offer, new equity is sold to outside shareholders, and the incumbent's controlling ownership will be diluted.").

196. Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 82 n.10 (citing Ganor, *The Power to Issue Stock*, *supra* note 25, at 709).

197. No. 2018-0342-AGB, 2018 WL 2263385 (Del. Ch. May 17, 2018).

198. *See id.* at *1; *supra* text accompanying notes 14–18.

199. *See, e.g.*, Mendel v. Carroll, 651 A.2d 297, 306 (Del. Ch. 1994) (recognizing the authority of the board to dilute a controller in order to protect the corporation consistently with its fiduciary duties); Ford v. VMware, Inc., No. 11714-VCL, 2017 WL 1684089, at *32 (Del. Ch. May 2, 2017) (citing Hollinger Inc. v. Hollinger Int'l, Inc., 858 A2d 342, 387 (Del. Ch. 2004)); *see also infra* text accompanying note 367.

explanation seems reasonable on a theoretical ground, the board might also practically seek to dilute the controller for opportunistic reasons. There are several instances of disagreement between the managers and the shareholders that can result in an incentive of the former to weaken the influence of the latter. The ultimate purpose might be either to perpetuate their position or to have more autonomy in the firm's strategic decisions.

Issuing blocks of shares to sympathetic investors is the most immediate way to accomplish the goal, with the expectation that the new friendly blockholders support management entrenchment.[200] Notably, the emergence of new blockholders is not restricted to transactions limited to one or a few specific investors: it has been pointed out that the control-diluting equity issuances generally structured as cash offers are likely to result in the same effect.[201] The same study also explained that in the event that an investor seeks to exercise influence over an issuer, the new equity issuance may facilitate her goal in that the odds of success are higher, and the costs are lower, compared to the case of an ordinary purchase on the market.[202] Accordingly, the ultimate goal of such intruding blockholders is often not to carry out monitoring activities but rather to threaten the controller to share a fraction of the control benefits.[203] Therefore, taking advantage of the shield of the threat to the long-term interests of the corporation, managers might cause an undisputed fundamental change in the ownership structure of the firm, such as a change of control, or at least a loss of control, which undermines the influence of the incumbent controller.

The purpose of Part III was neither to advocate that the managers are likely to perpetuate self-interests while issuing new shares nor to assume this attitude but to point out that as much as shareholders have an interest in not being either voting or economically diluted, the managers *might* have an opposite opportunistic incentive to enter into selective issuances. Overall, it seems reasonable to agree with the authoritative view that shareholders might want to keep direct control of such corporate decisions.[204] This is true both in the context of a manager-shareholder conflict and of a majority-minority shareholder conflict: the legal rules should protect shareholders as a class from exploitation by the managers and the minority shareholders —

200. *See generally* Kenneth A. Borokhovich et al., *Variation in the Monitoring Incentives of Outside Stockholders*, 49 J.L. & ECON. 651 (2006) (suggesting that affiliated blockholders may be deferential with regard to managers' entrenchment in exchange for sharing control benefits).

201. *See* Wu et al., *supra* note 177, at 1041 ("[C]ontrol-diluting cash offers tend to increase the probability for the emergence of new blockholders.").

202. *See id.* at 1042.

203. *See id.* at 1056.

204. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 180.

who face the most significant case — from exploitation by the majority should the majority shareholders, as often happens, exercise significant influence over the managers, who are entitled to approve the transaction. Part IV describes the powers that the current legal framework grants to the shareholders and argues that they fail to effectively limit managers' discretion in affecting the ownership structure of the firm.

IV. CURRENT SHAREHOLDERS' POWERS

Previous parts indicated that the U.S. legal framework provides the managers of a public corporation with comparatively great flexibility and discretion in issuing new shares. Shareholders do not have significant powers neither in affecting the decision nor in determining the structure of the transaction, and they mainly rely on the fiduciary duties that managers — and, under certain circumstances, controlling shareholders — owe to the corporation.[205] However, managers' powers in the issuance of new shares are subject to two quantitative limits that, if crossed, trigger a mandatory shareholder vote. This Part analyzes the cases requiring shareholder approval to issue new shares, with the goal — building on the analysis carried out in previous Sections — of critiquing the rules' effectiveness in limiting insiders' discretion. Namely, this Part is divided as follows: Section A delves into the voting power of shareholders that Delaware corporate law sets forth; and Section B analyzes the shareholder vote requirement provided by stock exchange rules.

A. Shareholders' Vote Pursuant to Delaware Corporate Code

According to the Delaware Code, the board of directors of the corporation may issue additional shares provided that the number of authorized shares in the certificate of incorporation is not exceeded.[206] Firms shall increase the number of the authorized shares only through an amendment of the charter of incorporation, which requires the approval of the shareholders.[207] This rule, however, does not prove to significantly limit the power of the managers to effectively address shareholder interests.[208]

A relatively recent extensive analysis of the allocation of powers in the equity issuances of Delaware corporations assessed the "magnitude of the

205. *See supra* Sections II.B, III.B.

206. DEL. CODE ANN. tit. 8, § 161 (2020).

207. *See* Min, *supra* note 89, at 294 ("Under . . . the corporate law of all 50 states, including the Delaware General Corporation Law, amending a corporate charter requires both directors' and shareholders' approvals.").

208. *See* GEVURTZ, *supra* note 35, at 135 (pointing out the minimal protection that this rule brings against the shareholders' dilution).

managers' power" in the transaction by focusing on the "excess ratio," which is the ratio of the (i) number of authorized non-outstanding shares (*i.e.*, the number of shares that the board of directors is empowered to issue without a resolution of the shareholders' meeting) to (ii) the number of the outstanding shares.[209] The analysis shows an average excess ratio of 5.79 with regard to non-financial corporations that went public in 2009, indicating that on average, each of these companies at the time of the initial public offering ("IPO") had issued less than one-sixth of the shares authorized by the corporation's charter.[210] It is an obvious remark that a very high ratio significantly weakens the purpose and the value of the shareholders' vote, in that it is seldom required. The same study also suggests that the managers' purpose to keep wide discretion in the stock-issuances may either result in them refraining from issuing shares for business purposes — even when it is the most suitable solution for the firm — or, more broadly, enhancing their incentive by entering into any business transaction that has a positive effect on the excess ratio (*e.g.*, choosing share repurchases instead of dividends as the form of cash distribution).[211] Therefore, the managers' power to affect the ownership structure of the firm, combined with the agency tension between the managers and the corporation as a whole, is capable of indirectly creating distortions over their business decisions should their priority be to retain or to enhance the magnitude of this power.

From a normative perspective, one might suggest imposing a cap on the excess ratio to limit the magnitude of the directors' power. However, that proposal fails to address at least some of the above-mentioned issues. First, it is reasonable to argue that the lower the excess ratio is, the more likely the managers' business decisions are to be influenced by their effort to retain the power to dilute the shareholders' shares in the future.[212] Second, and more importantly, the shareholders' vote to increase the number of authorized shares generally fails to distinguish between the several types of equity issuances, and it is not contingent upon their different features (*e.g.*, identity of the purchaser and price). Therefore, it does not fix the flaws of the rule in

209. Ganor, *The Power to Issue Stock*, *supra* note 25, at 740.

210. *Id.* at 741 (providing a table showing a median excess-ratio for the same companies in the same year equal to 3.75 and a standard deviation of 5.13, which resulted from some companies choosing to go public with a very high ratio and others choosing a relatively small one, with the lowest at 0.34).

211. *Id.* at 705, 710–12 (explaining that since the managers do not have any power over the number of authorized shares, their business decisions might be influenced by the goal to increase the number of authorized and non-outstanding shares).

212. *See id.* at 742–43 ("[A] high ratio, which indicates a significant power in managers' hands, can be desirable to the extent that it allows the managers to issue stock without worrying about diminishing their power.").

protecting the outsiders from the above-mentioned scenario.[213]

The rule does not require firms to seek shareholder approval in the imminence of the shares issuance, meaning that as of the time of the vote, shareholders cannot be completely aware of the rationale of the transaction and of its effects on the ownership structure of the firm (including the dilution of a specific shareholder that may not be part of shareholders base as of the time of the vote).[214] This flaw is particularly critical in the non-controlled public corporation, where the shareholders' base may vary more often depending on the presence of either active or engaged shareholders. Second, in the context of controlled companies, the charter amendment does not distinguish between issuances involving the controlling shareholder and those where the purchasers are public shareholders not related to her.[215] Indeed, a controller may easily approve the charter amendment thereby succeeding the hypothesis described in Section III.B.i.[216] For a similar reason, the solution does not fix even the issue presented in the case *CBS v. NAI*, unless the amendment process was carried out exactly just before the proposed transaction.[217]

B. Shareholders' Power Pursuant to Stock Exchange Rules

Rules that U.S. stock exchanges adopt usually require the shareholders' approval when the equity issuance has a material impact on the voting rights balance of the public company.[218] Namely any issuance either resulting in a change of control of the issuer or having a voting power above twenty percent of that of the outstanding shares, triggers the shareholder vote provision.[219] This limit seems more effective than the one that the previous Section discussed since it maintains a vote on the specific transaction. In other words, when shareholders' vote, they have (or at least they are

213. *See supra* Part III.

214. DEL. CODE ANN. tit. 8, § 161 (2020).

215. *See id.*

216. *See* Ventoruzzo, *supra* note 22, at 519 ("[M]inority shareholders in corporations with a controlling shareholder derive little protection from this rule because majority shareholders can consent to increase the number of authorized shares."); *see also* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 943 (explaining how this protection proved to be useless in the Google recapitalization of 2012, where the founders holding the majority of the voting rights were able to approve the issuance of a new class of shares although they "were clearly self-interested").

217. *See supra* text accompanying notes 14–18 for a detailed discussion of the case.

218. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 180–81 ("U.S. listing requirements require a shareholder vote when a new issue of shares is large enough to shift voting control over a listed company . . . .").

219. NYSE, LISTED COMPANY MANUAL § 312.03(c) (2019); *see also* NASDAQ RULE 5635 (setting forth a similar provision to the NYSE rule).

reasonably supposed to have) a clear view of both the terms of the transaction including the price, the subscribers' identity, and the transaction's impact on the ownership structure of the corporation. However, some concerns remain from the substantive and procedural perspectives.

On the substantive side, the New York Stock Exchange ("NYSE") rule provides for an exemption in the event of a cash offer to the public.[220] Therefore, the rule limits the flexibility of management to privately sell blocks to sympathetic investors but fails to protect outsiders should the managers have the only goal of diluting one or several specific shareholders, which management could accomplish with an offering to the dispersed public investors (rather than having to act in concert with one or more specific purchasers).[221] Finally, the rule sets forth another exemption if the firm issues shares in exchange for cash consideration at least equal to the market price of the share.[222] Therefore, this provision excludes shareholder votes for all the cases of non-cheap share issuances: although the approach to focus only on the exploitation of economic value might be reasonable, since the source of the provision is a stock exchange regulation, it arguably does not fulfill the protection of all shareholders' interests by itself. In fact, the same critiques concerning the application of the price fairness scrutiny to new share issuances[223] apply to this rule with a stronger magnitude given that the market price is possibly below the fair price in a transaction reallocating voting rights. In addition, having recently further increased the flexibility of the issuer with regard to the minimum price, the stock market rule is even more exposed to the critique that it fails to consider that the value

220. Note that these exemptions do not apply in the case of the issuance shifting the control of the issuer. *See* JOSHUA N. KORFF ET AL., NYSE IMPROVES 20% RULE REQUIRING SHAREHOLDER APPROVAL OF CERTAIN PRIVATE PLACEMENTS 2 (2019), https://www.kirkland.com/-/media/publications/alert/2019/02/nyse-improves-20-rule-requiring-shareholder-approv.pdf.

221. *See id.* at 1.

222. NYSE, *supra* note 219, §§ 312.03(c)(2)–312.04(i) (explaining that "shareholder approval will not be required for any such issuance involving: any public offering for cash; or any other financing (that is not a public offering for cash) in which the company is selling securities for cash, if such financing involves a sale of common stock, . . . at a price at least as great as the Minimum Price," where the definition of Minimum Price is "a price that is the lower of: (i) the Official Closing Price immediately preceding the signing of the binding agreement; or (ii) the average Official Closing Price for the five trading days immediately preceding the signing of the binding agreement"); *see also* Eleazar Klein & Evan A. Berger, *SEC Approves NYSE's Amended "Related Party" and "20%" Stockholder Approval Rules*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 20, 2021), https://corpgov.law.harvard.edu/2021/04/20/sec-approves-nyses-amended-related-party-and-20-stockholder-approval-rules/ (discussing a recent amendment to the rule, which removed the "5% limit for any single purchaser participating in a transaction").

223. *See supra* text accompanying notes 41–59.

of the voting right is subjective, since the stock market rule increases the likelihood that the shareholders' vote is not triggered even if the issuance price is below the diluted shareholders' subjective value of their voting rights.[224]

From a broader and procedural perspective, the rule has been recently called into question in the context of the *CBS v. NAI* case, as the highly dilutive dividend that the managers of CBS approved would have deprived NAI of the issuer's control.[225] Given that Delaware courts did not rule on the matter, it is not clear whether CBS' directors relied on any exemption to the rule or if this structure was effectively compliant.[226] A post from the law firm Cleary Gottlieb Steen & Hamilton argues that "the CBS-NAI situation should serve as a reminder that stockholders should be wary of relying too heavily on stock exchange rules as protection against potential dilutive stock issuances."[227] The main argument is the potential lack of enforcement power of stock exchange rules that are likely to not have the force of law.[228] The lack of shareholder power for enforcing the stock exchange rules appears to be abstracted from a series of cases, including a recent 2005 ruling of the U.S. District Court for the Southern District of New York.[229] The Cleary Gottlieb Steen & Hamilton post further indicated that the board of directors

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224. NYSE has recently amended the rule in order to eliminate the requirement for shareholder approval in the event that the issuance price falls between the Minimum Price and the book value of the stock. *See supra* note 222 (defining Minimum Price); KORFF ET AL., *supra* note 220, at 1 (pointing out that the new rule enhances the flexibility of the issuer).

225. *See supra* text accompanying notes 14–18.

226. *See* Victor Lewkow et al., *Lessons from the CBS-NAI Dispute: Can Stockholders Rely on Stock Exchange Rules to Prevent Dilution of Their Voting and Economic Interests?*, CLEARY GOTTLIEB (Oct. 10, 2018), https://www.clearygottlieb.com/news-and-insights/publication-listing/lessons-from-the-cbs-nai-dispute-can-stockholders-rely-on-stock-exchange-rules-to-prevent, *reprinted in* Victor Lewkow et al., *CBS-NAI Dispute, Part III: Can Stockholders Rely on Stock Exchange Rules to Prevent Dilution of Their Voting and Economic Interests?*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 24, 2018), https://corpgov.law.harvard.edu/2018/10/24/cbs-nai-dispute-part-iii-can-stockholders-rely-on-stock-exchange-rules-to-prevent-dilution-of-their-voting-and-economic-interests/ (suggesting firstly that the CBS issuance might have been grounded in an NYSE statement on the twenty percent rule that affirms it "does not apply to stock dividends and splits because they are distributions rather than transactions" and exhorts stakeholders to focus on the actual intent of the issuance, and secondly arguing that the NYSE statement was unlikely to be applied to dilutive dividends as the main purpose was to focus on effective distributions). A ruling on the matter is not available since the dispute ultimately settled. *See* Settlement and Release Agreement, *In re* CBS Corp. Litig. (No. 20180343-AGB) (Sept. 9, 2018), https://www.sec.gov/Archives/edgar/data/813828/000119312518269601/d622048dex10a.htm.

227. Lewkow et al., *supra* note 226.

228. *See id.*

229. Brady v. Calyon Sec. (USA), 406 F. Supp. 2d 307, 312 (S.D.N.Y. 2005).

might be willing to take the risk of having the company delisted (the principal sanction that the stock exchange may enact) in order to achieve their goal.[230]

In conclusion, the stock exchange rules do not seem to be a reliable source of protection for shareholders seeking to avoid a dilution of their fractional stake. Not only do they fail to address some specific instances, but there are issues concerning their overall enforcement. Furthermore, any decision maker or transaction planner of the firm is likely to structure the transaction in order to take advantage of these gaps and avoid the shareholders' vote:[231] were the voting requirement set forth by Delaware corporate law, their task would be at least harder. Finally, this Article advocates a consistent body of rules set forth by corporate law rather than by stock exchange regulations and that do not discriminate based on the stock exchange where the corporation is listed.

V. A NORMATIVE APPROACH TO THE EQUITY ISSUANCES

The analysis so far can be summarized as follows: (1) the issuance of new shares might have a material impact not only on the corporation's finance but also on its governance; (2) the current ownership structure of public firms witnesses several instances of shareholders who are concerned about the dilution of their stake, and the entire fairness standard does not address this problem; (3) the managers may use this tool to exploit shareholders' value; and (4) the current shareholders' powers do not effectively protect them from the managers' exploitation. This Part seeks to propose a new legal framework that arguably better addresses shareholders' concerns of enhancing their powers in the context of new equity issuances. This normative approach arises from the comparison with the rules that, in compliance with EU laws (when applicable), the EU countries adopt.[232]

230. *See* Lewkow et al., *supra* note 226 (pointing out that the firm is "aware of at least one situation where the board of a major company seemed to be prepared to not comply with the NYSE Policy in the context of a competitive M&A situation, after receiving advice as to the likelihood of an NYSE enforcement action and the likelihood of other trading markets developing in the event of a delisting" and specifying that the transaction had not been completed for different reasons). On the point, see generally Steven Davidoff Solomon, *Warren Buffett's Lost Vote*, N.Y. TIMES, (Jan. 21, 2010, 9:05 AM), https://dealbook.nytimes.com/2010/01/21/warren-buffetts-lost-vote/?src=tptw, for the argument that if a company is not required to be listed, it may be willing to accept this extreme solution.

231. *See* Marco Becht et al., *Does Mandatory Shareholder Voting Prevent Bad Acquisitions?*, 29 REV. FIN. STUD. 3035, 3040 (2016) (exposing relevant literature and cases).

232. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 181 ("EU jurisdictions have a stronger tradition of putting new share issues to the vote of shareholders, although

Namely, as a default rule, (i) shareholder consent is required to approve the issuance and (ii) once the transaction is approved, shareholders are entitled to subscribe pro-rata to the newly issued shares. The remainder of this Part is structured as follows: Section A focuses on the preemptive right provision and points out why it fails to address the issues flagged in previous parts; and Section B focuses on shareholders' approval — which is arguably the most suitable improvement — and seeks to understand the best possible implementation in order to address the above-mentioned problems.

A. The Preemptive Right in Public Companies

The preemptive right is the right of existing shareholders to subscribe pro-rata to the newly issued shares.[233] It is a default provision in European countries, where it can be partially, or entirely, waived should certain specified exemptions be met.

Supporters of the preemptive right claim its effectiveness in protecting outsider shareholders from dilution by the decision makers of the new equity issuances, either the controllers or the managers depending on the circumstances. While the provision is undoubtedly a useful tool from the perspective of the firm's majority shareholder, who is able to retain her fractional economic and voting power within the firm, the majoritarian view addresses the provision as a minority's tool in the context of the conflict against the majority.[234] Arguably, the controller is supposed to find protection from any dilution in the dominant (*i.e.*, controlling) influence that she can exercise over the managers.[235]

Looking at the function of the provision, some scholars claim that the main purpose is to prevent the exploitation of minority shareholders' economic value.[236] Namely, it has been indicated that, should the issuance of shares be

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the company's charter or the shareholders in general meeting may delegate that decision to the board, for periods of up to five years."). *See generally* Ventoruzzo, *supra* note 22 (providing a comparative analysis between corporate laws and specifically new share issuances in Europe and the United States).

233. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 83.

234. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 182 (pointing out how "[p]reemptive rights are a paradigmatic example of the sharing strategy" as a way to protect minority shareholders).

235. *See* GEVURTZ, *supra* note 35, at 134 (noting that a controller who is not willing to be diluted is presumed to block the issuance).

236. *See* Amal Abu Awwad, *Diritti di Opzione nelle Società Quotate e Non Quotate e Metodi di Protezione* [*Shareholders' Preemptive Rights in Listed and Closely-Held Corporations and Shareholders' Protection Methods*], 11 NUOVO DIRITTO DELLE SOCIETÀ [NEW CORP. L.] 142, 144, 157 (2013) (It.) (pointing out that for public corporations, market liquidity might be a suitable replacement of preemptive rights since

underpriced, the outsiders have the option to purchase a proportional fraction of the new equity and therefore offset the decline in their existing stake's value with the gain they capture in the purchase of underpriced new shares.[237] Transfer of value occurs only should the existing shareholders fail to completely exercise their respective preemptive rights.

However, other scholars pointed out how the preemptive right enables the existing shareholders to retain their fractional voting power.[238] Reasonably, both explanations are correct and retaining the same proportional stake is a way to avoid economic dilution.[239] Since preemptive rights fulfill both protections, wondering about the main function of the provision may seem a speculative and pointless exercise; however, it is critical to assess the provision's efficiency and effectiveness, as well as whether its goal could be better achieved otherwise. To this extent, the preemptive right indirectly leads the corporation to keep the same ownership structure, and it has been pointed out that this interest is perceived as compelling mainly in closed corporations.[240] Although the restatement of the preemptive right as a default provision in the issuance of new shares does not seem to be the best solution to address the issue of shareholder dilution, this Article disagrees with this statement and claims that outsider shareholders of public corporations do have some interests in limiting the discretion of the managers in diluting shares.[241]

The provision also encourages a dialogue between managers and shareholders in that the latter have to approve of any waiver of the preemptive right.[242] Arguably, the magnitude of the argument on the engagement between insiders and outsiders depends on the strictness of the requirements that the applicable law maintains in order to waive the

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any diluted shareholder is able to purchase additional shares on the market); *see also* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 83 (suggesting that the feature enabling shareholders to retain the same fraction in the ownership structure of the firm is an indirect protection).

237. *See* Holderness & Pontiff, *supra* note 29, at 253.

238. *See* MYNERS, *supra* note 60, at 10–11.

239. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 182 ("[P]reemptive rights permit minority shareholders to safeguard their proportionate investment stakes and discourage controlling shareholders from acquiring additional shares from the firm at low prices.").

240. *See* Abu Awwad*, supra* note 236, at 149 (arguing that mainly shareholders of family-owned companies have this concern).

241. *See supra* Part II.

242. *See* FERRAN & HO, *supra* note 32, at 106; Eilís Ferran, *Legal Capital Rules and Modern Securities Market — the Case for Reform, as Illustrated by Equity Markets*, *in* CAPITAL MARKETS AND COMPANY LAW 115, 121–22 (Klaus J. Hopt & Eddy Wymeersch eds., 2003).

shareholders' preemptive rights.

Differing from EU jurisdictions, the U.S. legal framework does not empower existing shareholders with preemptive rights, which are only an opt-in option[243] and are rarely implemented into corporate charters.[244] Namely, the preemptive right quickly and unsuccessfully appeared in the United States and its importance started to decline around the second half of the twentieth century.[245] Nowadays, the main mechanism for shareholder protection lies in the application of directors' fiduciary duties to new share issuances.[246] In the relatively few cases where the issuers decide to provide existing shareholders with preemptive rights in a specific issuance, the transaction is structured as a rights offering.[247] This historical evolution may be a reason not to argue for the implementation of preemptive rights in the United States; however, it is not the only argument.

An additional argument lies in the provision's function to protect outsider shareholders from underpriced issuances. The approach that this Article seeks to suggest concerns the economic side of the transaction and advocates the enhancement of shareholder protections from economic dilution through the improvement of the overall process of new share issuances. This seems to be the established trend in Delaware law with regard to different corporate law transactions entered into by public corporations.[248] In fact, the legal approach that Delaware courts repeatedly adopt is to assess the fairness of the price to the minority shareholders in controlled transactions through the quality of the process.[249] The argument is to extend the attitude that was

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243. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 182; *cf.* Abu Awwad, *supra* note 236, at 156–57 (suggesting that the policies of the United States and European countries are converging with regard to the use of preemptive rights in public corporations).

244. *See* CLARK, *supra* note 37, § 17.1.4.

245. *See* Ventoruzzo, *supra* note 22, at 520–21.

246. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 84.

247. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 353; *see also* Massa et al., *supra* note 30, at 6, 13 (describing the procedure of a rights offer).

248. *See generally* Guhan Subramanian*, Appraisal after* Dell, *in* THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP? 222 (Steven Davidoff Solomon & Randall Stuart Thomas eds., 2019) (arguing that in the context of appraisal proceedings, the deal price should receive a material presumption of fairness if the courts find the deal process to have been at arm's length).

249. *See id.* at 236 ("[T]he Delaware Supreme Court converted a substantive inquiry (Was the deal price entirely fair to the minority shareholders?) into a procedural inquiry (Did the minority shareholders have adequate procedural protections?)."). Subramanian mentioned the case *Kahn v. M&F Worldwide Corp.* as a paradigmatic example of his statement. *Id.* (citing Kahn v. M&F Worldwide Corp., 88 A3d 635 (Del. 2014)).

endorsed in the context of freeze-out transactions and appraisal proceedings to the equity issuances, which to an extent are comparable cases because the broad purpose of corporate law in such instances is to protect outsider shareholders from possible abuses of managers through the transaction.

On this side, the preemptive right fails to enhance the quality of the process, as well as the fairness of the price. Contrarily, the cornerstone of the provision is that, should the issuance price be below the fair market value of the shares, the loss that existing shareholders incur is offset by the right to purchase pro-rata new shares at a price that is advantageous from the purchaser's perspective.[250] Alternatively, the existing shareholders may sell their preemptive right. In sum, the incentive to focus on the quality of the process is arguably undermined by the purported lack of interest in the existing shareholders that may recover the unfairness of the price through subscription rights. On that point, financial studies noted that, customarily, rights offers provide "a 10-15% discount from the stock's current market price."[251] The preemptive right is an ex-post remedy (with the weaknesses that authoritative scholars pointed out and this Section has exposed) to limit the negative impacts of a flawed process, rather than a tool to improve the quality of the process itself.

To this extent, a further critique of the provision is its necessary reliance on the efficient functioning of the financial markets. Namely, as above mentioned, the provision's main purpose is to protect outsiders from economic exploitation and this purpose is only achieved if there is a full exercise of the rights, should the offer be underpriced. Therefore, the provision is flawed for those shareholders whose financial or other constraints prevent them from exercising their rights.[252] The traditional solution lies in a shareholder's ability to sell the right to another investor;[253] should the rights market be not sufficiently liquid or non-tradable, the recommended approach for existing shareholders is to exercise the right and sell the share immediately after the purchase[254] or to sell the shares before

250. *See* Ventoruzzo, *supra* note 22, at 520 (explaining that the traditional approach in the United States was to grant shareholders the right to purchase pro-rata any new shares issued).

251. B. Espen Eckbo, *Equity Issues and the Disappearing Rights Offer Phenomenon*, 20 J. APPLIED CORP. FIN. 72, 72 (2008).

252. *See* GEVURTZ, *supra* note 35, at 135 (pointing out the flaws of preemptive rights in protecting a shareholder "who lacks either the funds or the willingness to take advantage of the right by purchasing more shares").

253. *But see* Massa et al., *supra* note 30, at 2 (indicating the problematic side of this alternative in that shareholders who fail to communicate their preference between subscribing and selling incur a loss).

254. Holderness & Pontiff, *supra* note 29, at 261.

the distribution of the right. In each case, the protection of the investor is shifted to financial markets: a recent financial study suggested that if the right is non-tradable, shareholders often seek to sell their shares before receiving the right (if they do not plan on exercising it).[255] The resulting pressure to sell, therefore, undermines the value of the right.

In addition, the preemptive right fails to fulfill the protection of certain shareholder interests pointed out in previous Parts[256] because it concerns both non-controlled and controlled corporations. To begin with, the preemptive right forces the outsiders to choose between being diluted and increasing their overall investment in the firm.[257] This is a critical concern, particularly for embedded shareholders who cannot increase their economic exposure in the firm, and institutional investors or hedge funds that may not want to increase their exposure in the firm by investing too many resources.[258]

In addition, the fact that the outsider shareholders subscribe to the new shares does not imply, by itself, that they are not being exploited for economic value.[259] Namely, as mentioned, the controller may have an interest in the firm issuing shares that are either absolutely overpriced — with the controller voluntarily refraining from the purchase of the new shares — or relatively overpriced, meaning that the insider seeks to extract private benefits from the firm and this makes the purchase of new shares convenient for her at a price above their fair market value.[260] The preemptive right fails to address the shareholders' concerns in all cases where the issuance is not underpriced, since it grants the outsider shareholders the right to purchase the new shares at a disadvantageous price. The facts of the above-mentioned *OTK v. Friedman* case are aligned with this argument.[261]

Recent studies indicated that the lack of adequate information undermines the effectiveness of the preemptive right in protecting the minority

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255. Wai-Ming Fong & Kevin C.K. Lam, *Rights Offerings and Expropriation by Controlling Shareholders*, 41 J. BUS. FIN. ACCT. 773, 776 (2014) (hypothesizing a relation between the agency issue and the number of non-exercised rights).

256. *See supra* Section II.C.

257. *See* FERRAN & HO, *supra* note 32, at 124 (pointing out the coercive effect of the preemptive right provision, especially in the event of an underpriced offer, which often occurs with preemptive rights).

258. *See supra* text accompanying notes 145–47.

259. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 86 (pointing out both the cases of overpriced-issuance tunneling and minorities' fear of overpriced-issuance tunneling).

260. *See supra* Section III.B.i.b.

261. *See supra* Section III.B.i.b.

shareholders from cheap-stock tunneling.[262] Namely, the information asymmetry between the insiders and the outsiders — which enhances the disclosure rules that apply in the context of public companies —[263] prevents the outsiders from assessing whether the issuance price falls below or above the fair price of the issuer's shares. On that point, a recent empirical study involving the Hong Kong stock market found that agency concerns may prevent the shareholders from exercising their rights while, if the issuance was underpriced, the controllers, who often act as underwriters, strengthen their position at a deep discount.[264]

Were the shareholders fully informed, the preemptive right would be a more useful provision to avoid the cheap-stock tunneling, but this scenario is unrealistic in practice.[265] In the context of public companies, not even tradable rights are effective in solving the issue, since the purchaser of the right faces the same lack of information as the outsider shareholders.[266] A recent proposal claims that in the context of a right offering, the insiders' decision on the subscription is material information for the outsiders and suggests that outsiders should be allowed to condition the exercise of their rights on the insiders' decision.[267] However, the case of the relatively underpriced issuance undermines this solution, since the fact that an exercise price is convenient for the insider does not, by itself, make it convenient for the outsiders.

This flaw undermines the effectiveness of the provision not only in protecting the outsiders from cheap-stock tunneling and overpriced-stock tunneling but also in avoiding the decline in their voting power through the exercise of subscription rights. The fact that a given outsider shareholder has an incentive to retain her voting power does not necessarily mean that she is willing to overpay for the newly issued shares — or to incur such risk,

262. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 86. *See generally* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95 (discussing the pros and cons of preemptive rights in defending all shareholders from cheap-stock tunneling).

263. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 363.

264. Fong & Lam, *supra* note 255, at 787.

265. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 363.

266. Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 93.

267. *See* Mira Ganor, The Case for Non-Binary, Contingent, Shareholder Action 3, 23 (Feb. 2, 2020) (unpublished manuscript) [hereinafter Ganor, The Case for Non-Binary, Contingent, Shareholder Action], https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3530596.

since she does not know the range in which the price falls[268] — to achieve the goal. Therefore, building on these studies, it seems reasonable to argue that the information asymmetry is likely to frustrate the preemptive right's avoidance of voting dilution.

This analysis is consistent with the finding of a recent study, which focused on the impact of the announcement that a public firm has approved a new share issuance over the market price of the already traded shares of that issuer. The overall impact of new equity issuances is usually negative, and structuring the transaction as a rights offering does not change the outcome by itself. In other words, granting preemptive rights to existing shareholders does not result, by itself, in a positive effect on the shares' price, contrarily to what happens should the issuance be approved by the shareholders.[269]

B. The Proposal for Reform: Shareholders' Vote

The Italian experience may serve as a proper introduction to this normative Section. Italian law, pursuant to European rules, requires shareholders to vote on issuing new shares. Although, for reputational reasons, the board reasonably tends to engage with the major shareholders and secure consent ahead of proposing the resolution, there are two recent cases of shareholders that successfully opposed an increase in the number of outstanding voting shares.

In June of 2015, the French company Vivendi S.A. acquired a stake of 14.9 percent in Telecom Italia S.p.A. and, by December of 2015, had become its major shareholder with participation equal to 20.116 percent of the voting rights.[270] As of December of 2015, Telecom Italia S.p.A. had issued 13,499,911,771 share of common stock and 6,027,791,699 shares of non-voting stock.[271] At the shareholders' meeting on December 15, 2015, the

268. Specifically, the outsider shareholder does not know whether the newly issued shares are underpriced, relatively underpriced from the perspective of the controller, or absolutely overpriced.

269. *See* Holderness, *supra* note 107, at 427 (noting that "[w]hen there is no shareholder approval, average returns are typically negative and are sometimes large," but the announcement of a shareholder-approved right offering positively affects the stock price).

270. TELECOM ITALIA S.P.A, EXPLANATORY REPORT BY VIVENDI S.A. TO TELECOM ITALIA S.P.A. SHAREHOLDERS 1 (2015), https://www.gruppotim.it/content/dam/telecomitalia/en/archive/documents/investors/AGM_and_Meetings/2015/Explanatory-report-Vivendi-bis.pdf.

271. TELECOM ITALIA S.P.A, MEETING MINUTES OF TELECOM ITALIA S.P.A. ORDINARY SHAREHOLDERS' MEETING 1 (2015), https://www.gruppotim.it/content/dam/telecomitalia/en/archive/documents/investors/AGM_and_Meetings/2015/minutes-ordinary-shareholders-meeting-15-dic-2015.pdf.

board of directors of Telecom proposed an extraordinary resolution to convert each non-voting stock into one common stock.[272] If the shareholders had approved the transaction, the conversion would have diluted the voting rights of the common shareholders by 31.1 percent,[273] resulting in a dilution of Vivendi's stake below fourteen percent of the voting rights. Due to Vivendi's opposition — which in the same context successfully also achieved the appointment of four directors — the board's resolution failed to reach the necessary threshold to be adopted, and the number of issued common stock was not increased.[274] Notably, the proposed transaction was not technically an issuance of new shares for consideration but a recapitalization still aimed at significantly increasing the number of voting stock. Furthermore, this conversion would have prevented the shareholders from exercising preemptive rights that they are usually granted in equity issuances in Europe.

In December of 2018, the board of directors of Banca Carige S.p.A. proposed at the shareholder meeting to adopt a resolution empowering the directors to issue new shares in exchange for an amount equal to or up to €400 million.[275] According to the proposal, the board would have eventually determined the terms (including the number of new shares) of the transaction,[276] and existing shareholders would have been granted preemptive rights.[277] The proposal failed to meet the required votes even if

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272. Press Release, Telecom Italia, Telecom Italia Shareholders' Meeting Held (Dec. 15, 2015), https://www.gruppotim.it/content/dam/telecomitalia/en/archive/documents/media/Press_releases/telecom_italia/Corporate/Financial/2015/PR-AGM-15-12-15.pdf.

273. TELECOM ITALIA S.P.A., EXPLANATORY REPORT OF EXTRAORDINARY GENERAL SHAREHOLDERS' MEETING TO SHAREHOLDERS 12 (2015), https://www.telecomitalia.com/content/dam/telecomitalia/en/archive/documents/investors/AGM_and_Meetings/2015/English-Translation-of-directors-explanatory-report-EGM-151115.pdf. Note that the transaction, if approved, had a voluntary conversion and a mandatory conversion: since the first one had a more convenient term for the holders of non-voting shares, it is fair to assume that all the holders would have picked the voluntary option.

274. TELECOM ITALIA S.P.A., SUMMARY REPORT OF THE VOTES OF SHAREHOLDERS' MEETING 1 (2015), https://www.telecomitalia.com/content/dam/telecomitalia/en/archive/documents/investors/AGM_and_Meetings/2015/summary-report-of-the-shareholders-meeting-votes-15-12-2015.pdf; *see* Gaia Balp, *Activist Shareholders at De Facto Controlled Companies*, 13 BROOK. J. CORP. FIN. & COM. L. 341, 365–66 (2019).

275. BANCA CARIGE, BOARD OF DIRECTORS' REPORT OF THE THIRD ITEM ON THE AGENDA OF THE EXTRAORDINARY SHAREHOLDERS' MEETING 1 (2018), https://www.gruppocarige.it/grpwps/wcm/connect/265f54ba-ee55-41f7-9638-9bdb9d302435/03+Relazione+CdA+aumento+di+capitale_ENG+con+commenti+per+Legali+e+AS.pdf?MOD=AJPERES&CACHEID=ROOTWORKSPACE-265f54ba-ee55-41f7-9638-9bdb9d302435-mvMmw4h.

276. *See id.* at 1, 3 (citing Section 2443 of the Italian Civil Code, which expressly sets forth this alternative).

277. *See id.* at 9.

it did not undermine the shareholders' right to avoid dilution of their stake; therefore, the transaction was not completed.[278] Arguably the lack of approval of the issuer's major shareholder — carrying 27.5 percent of the voting rights — played a critical role.[279]

Taking advantage of the comparative experience, this Section seeks to put up a new legal framework aimed at addressing the corporate governance issues[280] that may arise in the context of the transaction, either in controlled or non-controlled public firms.

This Article applies Professor Bebchuk's argument that managers "should not have control over 'constitutional' decisions that affect the basic corporate governance arrangements to which the company is subject" to the transaction.[281] The proposed change lies in the allocation of powers between shareholders and managers and seeks to empower the former with a property rule protection. Therefore, shareholders may not be expropriated of their voting rights without their approval, notwithstanding the transaction's fairness.[282] Namely, the new rule requires the fully informed and uncoerced shareholders' vote to complete the transaction. While the raising of additional equity capital —– as well as the distribution — is a business decision, its potentially strong impact on the ownership structure of the firm

278. BANCA CARIGE, ASSEMBLEA ORDINARIA DEGLI AZIONISTI TENUTASI [ORDINARY SHAREHOLDERS' MEETING] 2 (2018), https://www.gruppocarige.it/grpwps/wcm/connect/b035d1ca-239a-44e7-9699-7561ac1c34ad/Elenco+Votazioni.pdf?MOD=AJPERES&CACHEID=ROOTWORKSPACE-b035d1ca-239a-44e7-9699-7561ac1c34ad-mvMmvbg (showing that despite the fact that more individual shareholders voted in favor of the proposal, the shareholders who abstained from voting held a larger percentage of the voting shares).

279. Raoul de Forcade, *Carige*, *Malacalza Si Astiene: Salta L'Aumento di Capitale da 400 Milioni* [*Carige, Malacalza Abstains: 400 Million Increase in Capital Falls Through*], IL SOLE 24 ORE (Dec. 22, 2018), https://www.ilsole24ore.com/art/carige-malacalza-si-astiene-salta-l-aumento-capitale-400-milioni-AEDylR4G (noting the impact of the abstention by a major shareholder, Malacalza Investments, on the ultimate fate of the proposal).

280. *See* Min, *supra* note 21 (manuscript at 13, 14) (claiming for a "distinctive treatment" of transactions that can potentially affect the governance of the firm).

281. Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 75, at 837. Note that while the Author develops this argument in a paper about public firms with dispersed ownership, the following Sections extend its application to the case of controlled firms, thereby seeking to limit the autonomy of the managers both when they act in conjunction with the controller or against her will.

282. *See* Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 601 (explaining that under property rules, "minority shareholders or courts cannot unilaterally take control rights away from the controller even for objectively fair compensation"). Notably, although Goshen and Hamdani addressed the rule from the perspective of the controlling shareholders, its features are the same both in controlled and non-controlled firms.

positions it as a fundamental corporate governance change.[283] Under the current legal framework, the assumption underlying the lack of shareholder approval for a new share issuance is that it does not fall within the corporation's fundamental changes unless it crosses the limit of the number of the firm's authorized shares by the charter of incorporation (as this specific case triggers the requirement of the shareholders' vote).[284] However, since this threshold is arbitrarily settled by the charter of incorporation and is usually very large,[285] it does not seem to be a good benchmark to capture the materiality of the change. For the same reasons, it should not be argued that the shareholders had in advance approved the transaction as of the time of the charter's amendment. A recent article points out the downsides of an allocation of power that entrusts the managers with decisions that may materially change the governance of a public firm:[286] in fact, this effect may be achieved even without having to increase the number of authorized shares. Another study extensively analyzed the allocation of power in the context of new shares issuances and found that "the power to issue stock in its current format enables managers to circumvent the will of the shareholders and promote the managers' own self-interest at the shareholders' expense."[287] Accordingly, the strategic selective distributions of the new shares (and therefore of newly created votes) to a board-friendly shareholder might substantially accomplish the same goal as the direct purchase of votes.[288]

CBS v. NAI differs from the other cases that this Article discussed in that the diluted shareholder was able to block the transaction.[289] In fact, the order endorsed the principle that the controlling shareholder is entitled to react to

283. *See* Min, *supra* note 21 (manuscript at 19) ("When a company distributes a newly created class of stock as a dividend, while the problems tend to be somewhat different, concerns over governance changes can nevertheless arise."). Notably, Min's paper applies this reasoning to all new share issuances regardless of whether they are structured as a distribution or not.

284. *See* Kim & Min, *supra* note 158, at 4 (pointing out a similar argument with regard to spin-off transactions, *i.e.*, "[a]n important assumption for such lack of shareholder approval in a spin-off is that there are no fundamental changes to shareholder rights before and after the spin-off").

285. *See supra* text accompanying notes 207–17 (discussing the other limits of the rule).

286. *See* Min, *supra* note 21 (manuscript at 24) ("As the CBS case demonstrates, directors' power to declare a stock dividend, if unchecked, confers significant power to the board and management to impact a company's governance structure.").

287. Ganor, *The Power to Issue Stock*, *supra* note 25, at 707.

288. *See id.* at 733.

289. *See supra* text accompanying notes 14–18.

the managers' action diluting her voting power.[290] However, as previous parts pointed out, the controlling shareholders may not be the only parties concerned with dilution and interested in opposing the managers of a public firm. While the case shows that the controllers — even when they lack control over the board of directors in the context of the transaction — are usually empowered with some instruments to neutralize the management's action and prevent the dilution of her participation, the other more or less significant but non-controlling shareholders lack any instruments. Arguably, the loss of a portion of voting rights is not considered an expropriation, dissimilar from what occurs with the loss of control.

This Article claims that any voting rights dilution may prove to be an issue even if it does not shift the control of the firm and seeks to extend its scope to any equity issuances regardless of the presence of a controlling shareholder.[291] The ultimate goal of the proposal is to enhance the protection of the outsiders from the dilution that the insiders — whoever they are depending on the circumstances: controlling shareholders, managers or directors — may seek. It advocates a consistent framework granting the shareholders relatively homogenous powers (*i.e.*, proportional to the fraction of voting shares they own) and tailored to the specific issuance. Mirroring the structure of previous sections,[292] the rule may deem even the controller to be an outsider, depending on the degree of influence that she exercises over the corporation's decision maker with regard to the specific issuance.

Arguably, this suggested approach also improves the issuance process, in that it favors a constructive dialogue between shareholders and managers since in the large majority of cases, the insiders have a strong incentive to seek the approval of the outsiders.[293] On that point, reputational arguments make managers more careful to avoid submitting unfair proposals (or at least unfair to the majority of those entitled to vote) to the shareholders' vote, facing the risk of having the proposal rejected. The requirement of a shareholder vote on the transaction — and an increasingly intense interaction with the management — appears to be strictly connected to the sophistication of the shareholder base.[294] Although it might be argued that the customary

290. *See* CBS Corp. v. Nat'l Amusements, Inc., No. 0342-AGB, 2018 WL 2263385, at *6 (Del. Ch. May 17, 2018). Note that a definitive ruling on the item is not available since the dispute subsequently settled. *See generally* Settlement and Release Agreement, *supra* note 226 (detailing the settlement between the two parties).

291. *See* text accompanying notes 55–58.

292. *See supra* Section III.B.ii.

293. *See* Kim & Min, *supra* note 158, at 49–50 (pointing out the advantages of ex-ante shareholder approval in the context of spin-offs).

294. *See* Holderness, *supra* note 107, at 437 (wondering whether mandatory shareholder approval and the resulting increased engagement between shareholders and

retail shareholder lacks the financial resources to cast an informed vote and therefore finds it a burdensome task,[295] the previous Parts embrace a different view.[296] On that point, an authoritative work exposed the transformation of U.S. capital markets and claimed that the transformation resulted in a shift of control over corporate affairs from courts to markets:[297] accordingly, "the increased deference of the Delaware courts to market actors reflects the Delaware courts' correct understanding that sophisticated shareholders are better positioned to adjudge the merits of board decisions and to discipline disloyalty and incompetence."[298] To this extent, not only the sophisticated shareholders may properly vote on the transaction, but also they need this right to avoid an unduly dilution and carry out such monitoring activity, which now may take place ahead of the transaction rather than through subsequent litigation. In fact, the proposal is consistent with the expectations that the institutional shareholders shared: indeed, BlackRock has recently advocated for the requirement of shareholders' approval in the context of new share issuances.[299]

Finally, the proposal is consistent with the thesis of a study that analyzed the new issuance in several countries from the stock-price perspective and found an overall positive effect of the announcement of a shareholder-approved issuance on the market price of the firm's shares.[300] Accordingly, a reasonable explanation of the outcome lies in agency tensions that usually affect the issuance since, should only the managers approve the transaction,

managers would make the shareholder base more sophisticated).

295. Ganor, The Case for Non-Binary, Contingent, Shareholder Action, *supra* note 267 (manuscript at 2).

296. *See supra* Section II.C.

297. *See* Goshen & Hannes, *The Death of Corporate Law*, *supra* note 79, at 265.

298. *Id.* at 289.

299. *See* Barbara Novick, *Open Letter Regarding Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 3, 2018), https://corpgov.law.harvard.edu/2018/05/03/open-letter-regarding-consultation-on-the-treatment-of-unequal-voting-structures-in-the-msci-equity-indexes/ ("[S]hareholders should be able to vote on matters that are material to the protection of their investment including but not limited to changes to the purpose of the business, matters related to capital issuance such as dilution levels and preemptive rights, the distribution of income and the capital structure.").

300. *See* Holderness, *supra* note 107, at 425 (exposing the findings of an analysis carried out on public firms without differentiating the concentration of the ownership structure). Note that while a market-oriented critique of the proposed rule might argue that if it were a material improvement, the market would have already implemented it, these empirical outcomes might offer an adequate response. Namely, the positive market reaction to shareholder-approved issuances should be read as an implied incentive to add this feature in order to benefit from a better stock performance.

the investors perceive them as possibly perpetrating self-interests.[301]

Arguably, the framework should be declined in different ways depending on the structure of the transaction and the identity of the subscribers in order to properly address the relevant conflicts and risks of exploitation. In addition to the general features of the shareholder vote — arguably applicable to each case — the remainder of this Part seeks to focus on the different scenarios, explaining how the rule should be implemented and positioning it in the current case law and literature. Mirroring the distinction that Part III drew, Section V.B.i focuses on the case of dispersed public corporations, while Section V.B.ii focuses on the case of firms with a controlling shareholder.

i. The Rule for Non-Controlled Corporations

In a corporation where control is contested,[302] the transaction would require the approval of a plain majority of the shareholders. Professor Bebchuk's seminal work strongly advocates an overall increase in shareholders' powers in dispersed public companies and repeatedly labels certain changes in the category of the "rules-of-the-game,"[303] which "concern[s] the choice of the rules by which corporate actors play."[304] These rules mainly include amendments to the corporate charter and the state of incorporation of the firm and "generally require a vote of shareholder approval" on the managers' proposals.[305] While Professor Bebchuk argues for empowering shareholders to propose and adopt rule-of-the-game decisions, this Article suggests broadening the "rule-of-the-game" definition to encompass the issuance of new shares, regardless of whether it requires an amendment to the charter of incorporation (*i.e.,* exceeds the number of authorized shares). Although the rule generally limits the abuse of power by managers, it has a stronger impact on strategic issuances.

Namely, assuming that the managers seek to dilute a specific engaged or active shareholder, with the current allocation of powers, they may achieve the goal of preventing the shareholders from expressing their dissent.[306] Contrarily, under the proposed framework, although the to-be-diluted

301. *Id.* at 434 (finding that if the shareholder vote is intense and close to the issuance, the positive impact of the announcement over the stock price is further strengthened and pointing out that the structure of the issuance is irrelevant).

302. *See supra* Section II.A (analyzing shareholder-manager conflict in this context).

303. *See generally* Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 75 (suggesting that shareholder intervention power can be grouped into two categories: "rules-of-the-game decisions" and "specific business decisions").

304. *Id.* at 844.

305. *Id.* at 837.

306. *See supra* Section III.A.

shareholder would obviously not have the voting power to veto the issuance by herself, the shareholder class would be entitled to choose between the agenda of the shareholder and the managers when casting the vote. The vote on the transaction de facto moves forward on the agenda and, in the context of an activist campaign, the proxy contest. Therefore, in the event of the action of an activist hedge fund, the other shareholders could vote on her dilution by the managers, taking a position in favor of or against her interests. The scenario fits with the facts of *Third Point LLC v. Ruprecht*, where institutional shareholders joined the activist in the dispute.[307] Under the proposed scenario, they would have voted on the dilution of the plaintiff before it could be completed. The proposed rule increases the shareholders' powers in equity issuances and is likely to protect long-term shareholders' engagement, reducing the power of the managers to frustrate their activity.[308]

Finally, comparing the shareholder vote with preemptive rights, the proposal shares the feature of encouraging interaction between the managers and shareholders before a vote, given the former's incentives to propose a structure that is approved when it fulfills shareholders' expectations. However, the proposal does not condition protection on further economic investment in the firm[309] and seems to be a more flexible tool from the perspective of the managers. In fact, there are instances where managers may legitimately believe that broadening the ownership base of the firm fulfills the corporation's interest. In order to pursue this goal under the proposed rule, the managers would need the approval of the majority of shareholders with voting rights, while when the mandatory preemptive right applies, all the entitled shareholders will subscribe pro-rata.[310]

ii. The Rule for Controlled Corporations

Mirroring the analysis that Part III carried out, the application of the proposed rule is two-fold, depending on the participation of the controller in the transaction. As a general approach, the rule complies with the traditional mission of corporate law to protect the outsider shareholders from agency costs[311] without undermining the controllers' position. Namely, depending

307. *See supra* text accompanying notes 134–39.

308. *See supra* Section III.A.

309. *See supra* Part IV (acknowledging this downside of the preemptive right).

310. Even if we assume that under certain circumstances the preemptive right could be waived, the majority's approval of the voting rights on the preemptive right would be insufficient by itself to achieve the goal. Otherwise, if the consent of the majority of the votes was sufficient to waive the preemptive right, one of the main alleged upsides of the provision (*i.e.*, the protection of the minority shareholders) would be frustrated.

311. *See* Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 595.

on the circumstances, the controlling shareholder may be considered an outsider for the purpose of the transaction, and therefore granted a property rule protection. In fact, the criterion that positions the controlling shareholder in the group of outsiders or that of the insiders, is the percentage of the new shares that she subscribes to: she falls in the management group if she participates more than pro-rata to the new equity issuances and within the outsiders in the opposite scenario. The solution — which relies on the presumption that should the controller purchase more than her ratable shares, she has a strong influence over such decision[312] — is consistent with the general approach of corporate law in similar circumstances[313] and avoids disputes on whether the transaction falls in one category or the other by setting an objective quantitative threshold (*i.e.*, the percentage of shares that the controller subscribes).[314] Section V.B.ii.a focuses on the case of the controller subscribing more than pro-rata to the newly issued shares, while Section V.B.ii.b focuses on a different scenario where the shareholder either retains her fractional voting power or the managers dilute it.

a. The Case of the Subscribing Controller

In this scenario, the managers negotiate with the controller (or the controller-manager is issuing shares to herself) for a transaction that strengthens her voting power in the firm, since she purchases the new shares more than pro-rata. Within the group of the controlling shareholders, this Section positions the case of a quasi-controller seeking to achieve control of the firm through more than pro-rata participation in the equity issuance. As explained above,[315] in order to assess the existence of a (either de jure or de facto) controller — and therefore adopt the appropriate protections for the

312. Note the distinction between cases of, respectively, the subscribing controller and the non-subscribing controller. This is only aimed at declining different voting mechanisms with regard to the approval of a new share issuance and claiming that even a controller may be an outsider if she does not exercise any influence on the decision makers of the firm. Contrarily, this is not to suggest that the controlling shareholder should not be considered as such if the managers seek her dilution or to take a position on the debate concerning whether the control-assessment should focus on the single transaction or on the day-to-day management of the firm. *See* Lipton, *supra* note 156, at 1994 ("[D]espite the abundance of case law — decided both before and after *Corwin* — treating control over day-to-day management as a factor to be considered in the controller analysis, the *Corwin* court cast that aspect of the arrangement aside.").

313. *See* Min, *supra* note 21 (manuscript at 27–28) (advocating a new definition of pro-rata distributions entailing a breakdown between business and governance decisions).

314. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 944 (mentioning the Google case to point out the lack of a quantitative criterion to assess whether a disputed transaction is self-dealing).

315. *See supra* text accompanying notes 184–88.

diluted shareholders — the focus should be on the ownership structure of the firm after new share issuances. As indicated,[316] the controller might seek to exploit minority shareholders not only through the cheap-stock tunneling but also by issuing non-underpriced shares that reinforce her position and possibly result in midstream changes to the corporation's governance.[317] Either case claims for a protection of the rights of the minority shareholders, who do not share the benefit of the transaction with the controller and whose stakes are diluted. The traditional dichotomy in this context is between empowering the controller to reallocate the voting rights — protecting the outsiders with the entire fairness standard that the courts carry out after the completion of the transaction — or the minority shareholders to block the transaction, requiring the ex-ante approval of the majority of the minority shareholders ("MoM") to complete it.[318]

As of now, Delaware courts adopt either of the two approaches, depending on the choice of the controller-manager, and the controller-manager has the burden to prove that the transaction is entirely fair unless she has obtained the MoM.[319] From the perspective of minority shareholders, this system carries the same weaknesses and flaws of the plain entire fairness standard[320] since the controller, in the least favorable scenario that did not want to seek or was not able to achieve the MoM, may always return to judicial review: therefore, this framework is known as "voluntary MoM."[321] Among other things, it fails to consider that the value of voting rights is highly subjective.

The application of the mandatory shareholder voting rule seeks to exclude the vote of the controlling shareholders, therefore making the MoM a requirement to complete the transaction. This would have had a significant impact on several cases analyzed in Part I.[322] In *Reith v. Lichtestein*, the Delaware Court of Chancery applied the entire fairness standard to the

316. *See supra* Section III.B.i.b.

317. See Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 608 ("Controlling shareholders could theoretically enjoy more than their pro rata share of the business by using their control to change the firm's governance arrangements midstream either directly through changes in the charter and/or bylaws or indirectly through some business combination, such as a merger.").

318. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 963–66 (providing a detailed analysis of the upsides and downsides of each approach).

319. *See id.* at 950; Lipton, *supra* note 156, at 2005–06 (defining the procedure as "cleansing mechanisms" and describing the relationship between the shareholder vote and the presence of independent directors).

320. *See supra* text accompanying notes 41–59.

321. Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 978 ("Delaware doctrine does not *require* controllers to subject a self-dealing transaction to a vote by minority shareholders.").

322. *See supra* text accompanying notes 1–13.

issuance of the convertible preferred stocks and stated that the defendant had failed to prove it, notwithstanding a 31.5 percent premium over the shares' market price.[323] However, this did not prevent the controller from completing the transaction, with the only concern being subject to the entire fairness standard. Contrarily, under the proposed property rule, the minority shareholders would have been willing to block the issuance rather than being mere witnesses to the managers' negotiation of a transaction that granted the controller the absolute majority of the voting rights. In a similar way, the outsiders could have blocked the transaction in *Klein v. HIG Capital*, which was also eventually subject to an entire fairness judgment.[324] Arguably, *Corwin v. British American Tobacco* makes the argument even stronger.[325] Although the majority opinion of the court found British American not to be the controlling shareholder on the basis that it "could not and did not exercise actual control over the Reynolds [(the issuer)] board"[326] — therefore possibly undermining the application of the MoM under the proposal — strengthening the odds of a different outcome. In fact, the proposed rule strongly favors an assessment of a single transaction, considering the quantitative criterion of the percentage of the purchased shares. A forty-two percent shareholder who is the only purchaser of the new stocks and whose consideration is below the public closing price of the shares the day before the signing would be likely to be deemed a controller for the purpose of the transaction, therefore making the issuance subject to the vote of the diluted shareholders only.[327]

In addition to the already mentioned upside of the shareholder vote in general share issuances, recent studies demonstrate the benefits of minority shareholder approval in the specific context of transactions with controlling shareholders.[328] Building on this, another work has considered a similar solution, as a countermeasure to the cheap-stock tunneling.[329] An international empirical study examined the effects of the announcement of

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323. Reith v. Lichtenstein, No. 2018-0277-MTZ, 2019 WL 2714065, at *20 (Del. Ch. June 28, 2019).

324. Klein v. H.I.G. Cap., L.L.C., No. 2017-0862-AGB, 2018 WL 6719717, at *15 (Del. Ch. Dec. 19, 2018).

325. *See* Corwin v. Brit. Am. Tobacco PLC, 821 S.E.2d 729, 729, 751 (N.C. 2018).

326. *Id.* at 743.

327. *See id.* at 742.

328. *See generally* Fried et al., *The Effect of Minority Veto Rights*, *supra* note 159 (studying the effectiveness of veto rights for minority shareholders regarding "related-party transactions").

329. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 364 (acknowledging the massive benefit of majority-of-minority approval but also flagging the material costs that it carries).

an equity issuance on the trading price of the issuer and corroborates the proposal. While shareholder approval was found to have an overall positive effect on the market price of the shares, there were specific cases of negative perception by the market.[330] Accordingly, a possible explanation lies in the alleged incentive of the blockholder-manager to perpetuate self-interests through the equity issuance, without acting in the best interests of the corporation.[331] Indeed, the approval of the majority of the outsiders seems to fix the possible flaw of a plain shareholder vote in controlled firms.

Finally, the rule outperforms preemptive rights — which European legal tradition perceives as the landmark minority's antidilution tool — for several reasons. In *OTK v. Friedman*, the outsider shareholders would have had the power to block the transaction¸ rather than being offered the right to purchase pro-rata new shares at a twenty-six percent premium over their market price.[332] Not only do outsiders not need to increase their economic investment in the firm under the proposal, but also the proposal arguably addresses the information asymmetry issue.[333] While preemptive rights are effective only after the relevant constituency (either the shareholders or the managers) have approved the transaction, the vote on the transaction can block it.[334] Therefore, the rule shifts the burden (and, indirectly, the cost of the information asymmetry) onto the controller since each time that a minority shareholder feels that she lacks complete information to approve, she may simply vote against the transaction and in favor of the status quo. Since the proposal allocates the cost to the side that has complete information, it creates an incentive to disclose all the material information in order to achieve approval of the transaction.

By contrast, authoritative scholars have addressed the topic of protecting minority shareholders and pointed out how, differently from the case of the controller's dilution, the best fit for the protection of the minority shareholders is the liability rule.[335] Namely, a number of objections may be

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330. Holderness, *supra* note 107, at 434.

331. *Id.*

332. 85 A.3d 696, 707 (Del. Ch. 2014); *see supra* text accompanying notes 182–88.

333. *See supra* text accompanying notes 262–67.

334. Note that the expression "can block it" means that the shareholders can vote to block the transaction as it is structured at the time it is subject to the shareholders' approval. In fact, the failure to obtain approval does not prevent the company from completing the equity issuance. The structure of the transaction can subsequently be amended in order to obtain the approval of the majority of disinterested shareholders or to limit the participation of the controller up to her ratable new shares.

335. Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 610 ("[T]he tradeoff between minority protection and controller rights supports a liability-rule protection for minority shareholders to better balance minority protection against agency costs and preservation of idiosyncratic vision.").

raised against the mandatory MoM: the remainder of this Section exposes and tries to respond to several possible critiques to the proposal.

1. Costs

To begin with, corporate legal scholarship does not undermine the costs that seeking the consent of the MoM requires.[336] Making the approval a requirement to engage in the transaction rather than a condition for being granted the shield of the business judgment rule further strengthens the reasoning. Within the category of the proposal's costs, it has been authoritatively pointed out that the veto power of minority shareholders excessively limits the controllers and might prevent the firm from raising additional capital when useful or from completing efficient transactions.[337] This unfortunate effect may result either from a strategic decision of the minority shareholders — which may adopt an aggressive approach aimed at enhancing their benefit from the transaction — or from their mistake.[338] To this extent, a recent study — reporting on the case of a corporation whose shares' market price dropped after having missed the opportunity to grow — argued that the voluntary MoM (which reasonably should be identified as a liability rule protection)[339] should prevail over the mandatory MoM since it avoids the risk of hold-outs.[340] Finally, the adoption of such property rule possibly prevents the controller from completing any firm's recapitalization that she deems necessary to pursue her "idiosyncratic vision."[341]

However, the specific framework of the proposal and the unique features of the transaction hopefully address these concerns. Namely, the proposal does not seek to grant minority shareholders a general veto power on the new

336. See Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 364 (highlighting the benefit of MoM approval).

337. *See* FERRAN & HO, *supra* note 32, at 110.

338. *See* Goshen & Hamdani, *Majority Control and Minority Protection*, *supra* note 21, at 458.

339. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 978 (explaining how the controller's option to have the transaction approved without the minority's approval may affect the negotiation since "the controller and the minority shareholders[] negotiate 'in the shadow' of Delaware's fair-price requirement").

340. *See* Edward B. Rock, *Majority of Minority Approval in a World of Active Shareholders*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 105, 123 (Luca Enriques & Tobias H. Tröger eds., 2019) [hereinafter Rock, *Majority of Minority Approval*] (building on the example of the Cablevision case).

341. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 965 (stating that the concerns raised by giving minority shareholders a veto on the reallocation of control rights "suggest that while empowering minority shareholders will protect them from the risk of agency costs, it will also increase the risk of frustrating the controller's pursuit of idiosyncratic vision").

share issuances since the controller's vote is frozen only if she subscribes more than pro-rata. The difference is material since the failure to achieve the MoM — as well as the non-willingness to seek it — does not prevent the firm from engaging in any new shares issuances but rather implies that the transaction be structured in a different way to avoid the requirement.[342] In other words, the proposed rule does not undermine the controller's control over the capital structure of the firm[343] since should she deem it critical to quickly issue additional shares for any reason, she refrains from increasing her proportional stake in the firm and is not prevented from voting.[344] From this perspective, the new share issuances materially differ from the other conflicted transactions that have witnessed the application of the MoM in that its structure can easily be amended in order to lose the feature of being a self-dealing transaction. Deepening the hold-out concern, there are two different kinds of allegedly value-enhancing transactions that the public firm could miss because of the failure to achieve the outsider's consent. The first category — which belongs to the corporate finance side of the transaction — encompasses all the cases where raising additional equity capital is beneficial for the firm for any business reason, possibly connected to the potential for growth. However, in this scenario, the controller has the option to avoid any corporate governance effects, limiting her purchase to her ratable shares. Her voting rights would prevent the firm from losing interesting growth opportunities. In *Reith v. Lichtenstein*, the issuer was raising capital to fund an acquisition.[345] Under the proposal, the controller could either subscribe her ratable part or seek that the MoM increase her stake: each path could be an effective way to complete a valuable acquisition.

The second category is more problematic since the controller is mainly interested in the corporate governance side of the transaction. Namely, if she specifically deems the reallocation of voting rights necessary to pursue her vision and the issuance of new shares as only a tool to complete this reorganization rather than as a way to raise funds,[346] she would actually be prevented from successfully accomplishing her goal absent consent from the minority shareholders. While this undoubtedly exposes the controlling shareholders and the firm to the holdout risk, this scenario arguably requires

342. Note that the fact that the controller does not purchase more than pro rata does not mean that the preemptive right should be granted. In fact, the remaining part of the offer should be structured also as a private placement to an outsider or as a public offer.

343. *Id.* at 462 (arguing that control over the capital structure of the firm should belong to the controller).

344. *See infra* Section V.B.ii.b.

345. *See supra* text accompanying notes 1–5.

346. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 963–64.

the involvement of the shareholders' meeting and the consent of the minority shareholders, who have invested funds in the firm and should not be forced to accept a fundamental governance change without any consideration. In fact, this feature flags a material difference between the new share issuances and freeze-out transactions — the traditional field of the debate between the entire fairness standard and shareholders' consent. Namely, minority shareholders are diluted but are not part of the transaction, which is entered into by the firm and the new purchaser of shares (*i.e.*, the controller in the case at hand): they witness a dilution of their stake but do not receive any proceeds. This non-trivial difference calls for a stronger approach (mandatory MoM) for the dilutive equity issuances, compared to the freeze-outs (voluntary MoM) when the controller takes the company private by paying a premium of the share market price. The bottom line is that the proposal does not subtract any managerial decision from the controller's autonomy; oppositely, it distinguishes between the business decision (the above-mentioned "first category") and the extraordinary corporate governance decisions (the above-mentioned "second category"), which reallocate voting or control rights and require the shareholders' consent.

2. Lack of Flexibility

One of the intrinsic costs of the mandatory property rules — including the proposed one — is the material decrease in the issuer's flexibility. Professors Goshen and Hamdani, endorsing a contractarian approach, have recently advocated the adoption of a firm-by-firm approach that enhances the autonomy of the corporations' charters with regard to the allocation of power to redistribute control rights.[347] Accordingly, the institutional shareholders may effectively exercise a strong influence over the provisions of the corporate charter and, on the other hand, the protection of the controller's idiosyncratic vision should not be undermined.[348] However, in the context of new share issuances, the reliance on the charter of incorporation presents some of the flaws that this Article pointed out about the limit of the authorized shares.[349] Namely, as much as the latter proves to be ineffective since firms usually go public with a significant number of unissued authorized shares, controller-managers would likely be able to

347. *Id.* at 986–89; *see also* Klausner, *supra* note 113, at 1327–28 (exposing a review of the contractarian approach and explaining that according to its supporters, "contractual governance is seen as superior to legally imposed governance arrangements because firms are different along numerous dimensions and market forces create incentives to customize and to innovate").

348. Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 990–92.

349. *See supra* Section IV.A.

enjoy the same broad power in structuring the firm's pre-IPO charter of incorporation.[350] On the point, an authoritative opinion undermines the trust in IPO charters, finding that they are usually empty documents with regard to corporate governance provisions and mainly adopt default rules.[351] The Institutional Shareholder Service ("ISS") recently disclosed an update on its policy for voting on charter amendments and pointed out that pre-IPO boards usually try to include provisions aimed at increasing their insulation from post-IPO investors.[352] Reasonably, the argument that in the context of the IPO, public investors are more concerned with the share price than governance provisions in the firm-charter,[353] helps explain the empirical evidence and flaws in the allocation of powers at the IPO stage (including the high number of authorized non-issued shares). In addition, it seems reasonable to predict that during the corporation's life, any controller's amendment reallocating voting rights may occur only as an increase:[354] the case of a controller self-decreasing her power with regard to this critical governance issue appears very unlikely.[355] The complex process and the distortions underlining the charter amendments in midstream companies, as well as the power of the controller both before and after the IPO with regard to the issue, calls for a mandatory rule.[356]

Adopting the charter-oriented approach, the power of the controller would not result from her ability to deal with and reward public shareholders, but mainly from her bargaining power at the time of the IPO. It must be pointed out that an investor, which may or may not exercise a certain level of pressure at the time of the IPO, might find it difficult to predict the development of

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350. *Cf.* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 989–90 (arguing that minority institutional investors usually have decent power to suggest a pre-IPO amendment to the charter).

351. Klausner, *supra* note 113, at 1329–39; Lin, *supra* note 55, at 483–84 (exposing an updated literature review pointing out the flaws in the contractarian theory).

352. *ISS Releases 2016 Benchmark Policy Updates*, INSTITUTIONAL S'HOLDER SERVS., https://www.issgovernance.com/iss-releases-2016-benchmark-policy-updates-2/ (last visited Mar. 3, 2021) ("While some pre-IPO boards argue that these governance structures will benefit investors over the long run, few of them provide opportunities for post-IPO shareholders to ratify these provisions post-IPO.").

353. Lin, *supra* note 55, at 485.

354. *See id.* at 486 (discussing amendments in the context of takeover defenses and entrenchment provisions).

355. *See* Klausner, *supra* note 113, at 1348 (noting that empirical evidence shows that managers seldom initiate governance changes unless shareholders exert pressure on them). Notably, should a controller-manager be empowered to reallocate voting rights, the degree of pressure would be extremely weak.

356. *See* Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 75, at 867 ("Mandatory legal rules and reversible defaults are indeed desirable, taking as given the existing distortions in the charter amendment process.").

the firm and the degree of power that the founder should be entrusted with to reallocate voting rights. Therefore, an investor would be asked to enter into a blind decision and empower the founder with a blank check. Notably, the decision and the alleged pressure of the initial outsider shareholders bind not only themselves but also any other investors who might eventually purchase the firm's public shares. While this Article agrees with the intuition of an increased reliance on institutional shareholders' powers, it favors the use of such powers with regard to the specific transaction and not broadly to the charter of incorporation. Enhancing the shareholder powers with regard to voting rights — considering their increased sophistication and incentives — would help distinguish opportunistic value-destroying recapitalizations from value-enhancing ones, since only the latter are expected to receive the approval.[357] Finally, if the controller really seeks to increase her power to pursue her idiosyncratic vision — and she is not able to convince her public investors — she may always take the firm private and enjoy more autonomy. Although this transaction might require an increase in funding, the controller may resort to a private partner. Contrarily, if she is not able to convince either private or public investors of her plan, reasonably the "market check" of her vision did not work.

3. Effectiveness

A separate but connected critique has been made about the real effectiveness of the rule: arguably, in the context of a freeze-out transaction or a management buyout ("MBO"), the minority shareholders might be tempted by the idea of divesting and are unlikely to block the transaction absent a higher offer than the proposed one.[358] However, the fact that the shareholders are not part of the transaction and do not receive any monetary benefit during a new share issuance undermines this risk. Contrarily, the shareholder vote might effectively provide the unique benefit of a market check on the issuance price: in fact, once the proposed issuance price is public, a third party may offer to purchase the firm's shares at a higher price

357. *See* Lin, *supra* note 55, at 504 ("[E]mpowering shareholders would best mitigate the risks of midstream opportunistic change by controllers with leveraged control and would allow shareholders to adopt value-increasing midstream charter amendments.").

358. *See* Rock, *Majority of Minority Approval*, *supra* note 340, at 121, 123; Kastiel, *supra* note 189, at 100 (reporting that "[c]ritics of MFW often argue that giving shareholders the additional protection of a majority-of-minority vote adds little value because shareholders who suffer from information asymmetry will always vote for a good premium deal offered by the controller" but also pointing out that in a M&A deal, an informed activist shareholder — if present — would be able to use the MoM to obtain a higher premium, therefore benefitting all shareholders).

(or to enter into any other transaction).[359] Namely, although the controller may claim that she should be the purchaser in light of her "idiosyncratic vision" and her business plan, she would still have a problematic task in explaining why she should be preferred against a more economically rewarding offer for the company. *OTK Associates v. Friedman* experienced a similar situation:[360] the structure of the issuance (rights offering) required that the transaction be publicly pending for a longer period in order to let the shareholders exercise their rights and, during this period, a third party offered to purchase the share at a higher price. While the issuer ignored and did not disclose the offer, under the proposed rule, shareholders would have to vote on the alternative to accept.

4. Coerced Vote

The intrinsic flaw of any shareholder veto power — a broad family which encompasses the MoM — concerns the possible coercion of the vote by the decision maker who submits the resolution. However, the presence of a controller amplifies the risk.[361] Arguably, in the context of this transaction, this issue is hardly avoidable from an ex-ante perspective, although it might be limited. The proposed framework, requiring the full and uncoerced vote of the MoM acknowledges that the approval of the MoM might not be sufficient to guarantee the effectiveness and the value-maximization of the process and the protection of minority shareholders. In fact, the insider might condition the completion of an objectively value-enhancing transaction on the approval of a new share issuance that the outsiders would not have otherwise approved.[362] However, the proposal does not set forth a practical solution to the case of a coerced vote, nor a tool to exacerbate those circumstances. While the overall goal of the proposal is to deal with the

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359. *See* Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 1, 53 (2005) (explaining the market check upside with regard to the MoM in a freeze-out transaction). Notably, the timeframe of the market check is reasonably shorter in new share issuances in order to not paralyze the business of the firm.

360. *See supra* text accompanying notes 182–188.

361. *See* Lipton, *supra* note 156, at 1982–83 (noting that the presence of a controlling shareholder alone may suffice to make the vote coerced without the need for the controller to take further threatening action).

362. *See* Sciabacucchi v. Liberty Broadband Corp., No. 11418-VCG, 2018 WL 3599997, at *6 (Del. Ch. July 26, 2018) (explaining that the value-enhancing acquisition was contingent on the approval of a dilutive new share issuance); *see also* Rock, *Majority of Minority Approval*, *supra* note 340, at 124 (pointing out the issues arising from a coerced vote in the MoM approval); Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 75, at 864 (explaining the flaw of a shareholder veto right in public corporations should managers bundle "a value-decreasing rule change favored by management with a move that is value-increasing by itself"); Goshen, *The Efficiency of Controlling Corporate Self-Dealing*, *supra* note 33, at 428.

issue from an ex-ante perspective, it appears hard to avoid court intervention in such case. The most effective solution seems to be to empower the shareholders to seek a court's injunction ahead of the shareholders' meeting (*i.e.*, between the post of the proposed resolution and the expected day of the vote). The other, weaker but likely more flexible, remedy consists of liability protection after the vote and the completion of the transaction, against the controller-manager for having failed to submit to the outsiders a proposed resolution with an uncoerced vote. The first option — which completely avoids the liability protection — is likely to be a more useful tool in both addressing the problem and preventing it, since it allows the shareholders to affect the outcome of the meeting rather than operating as an ex-post remedy. However, the first option requires a prompt outcome of the court as to whether the vote is coerced or not. Notably, although it is critical to address the risk of a coerced vote — which would frustrate the purpose of the rule — the case must be distinguished from the mere walk away, or threat to walk away, from the overall deal by the controller.[363]

b. The Case of the Non-Purchasing Controller

The feature of this scenario is that the controlling shareholder does not purchase the new shares more than pro-rata and the transaction dilutes (or does not increase) her stake.[364] Thus, she is positioned within the outsiders of the group. The proposed rule is to let the controller vote and, therefore, condition approval of the transaction on the consent of the holders of the majority of the voting shares. Although the application of the shareholder vote facially resembles the case of the non-controlled firm,[365] the underlying policy debate is significantly different.

The Delaware court witnessed this scenario in the recent *CBS v. NAI* dispute and, in its order, acknowledged the "apparent tension in [Delaware] law between a controlling stockholder's right to protect its control position and the right of the independent directors . . . to respond to a threat posed by a controller, including possible dilution of the controller."[366] Namely,

363. *See* Subramanian, *supra* note 359, at 15 (exposing a practical case when, in the context of the negotiation of a freeze-out, the controller-alleged threat was "nothing more than an invocation of Alcatel's [*i.e.*, the controller] otherwise legal walkaway alternative").

364. *See supra* Section III.B.ii (analyzing the shareholder-manager conflict in this context). Note that, as mentioned, the case of the controller who does not purchase newly-issued shares does not consider the hypothesis of the controller who voluntarily refrains from purchasing new (and overpriced) shares.

365. *See supra* Section V.B.i.

366. CBS Corp. v. Nat'l Amusements, Inc., No. 0342-AGB, 2018 WL 2263385, at *5 (Del. Ch. May 17, 2018).

corporate law may lay on the managers' side — empowering them to dilute the controller threatening the corporation[367] — or on the controller's side, protecting her rights with a property rule.[368] According to a recent scholarship commenting on the mentioned dispute, the position of the board "had some merit."[369] The proposed rule significantly undermines (if not completely nullifies) this power of the directors to fight against a controlling shareholder allegedly abusing her status and destroying the firm's (and minority shareholders') value, on the ground that, from a policy perspective, there is a strong case to enhance the controllers' rights.

Professors Goshen and Hamdani recently argued that in the context of a concentrated ownership structure, the managers should not be empowered to expropriate controllers' power and, therefore, called for a propriety-rule defending the controlling position, applicable also in the context of "a broader — and less intuitive — range of corporate actions, where corporate-law doctrine is less clear" and may result in the dilution of the controller's position.[370] Arguably, the property-based protection should not be limited to the controller of a firm with concentrated ownership — who invests a significant amount of resources to achieve and retain her influence — but extended to the firms adopting a dual-class structure. Not only does Delaware law (as last interpreted in *CBS* v. *NAI*) value control in dual-class firms, but policy considerations also call for this approach. Namely, a recent study pointed out the value of the non-voting shares — an extreme case of dual-class structures — in that they efficiently allocate the voting rights to the shareholders that value them the most and help make the management accountable to the informed and motivated shareholders.[371] Clearly,

367. *See id.* at *6 (reviewing the case law affirming this argument); *see also supra* text accompanying note 199.

368. *See id.* (quoting passages of the cases that explicitly drew the power of the controller to respectively "avoid its disenfranchisement as a majority shareholder" and "prevent the issuance [which would have destroyed his voting control] by unseating directors"); *see also* Adlerstein v. Wertheimer, No. CIV. A. 19101, 2002 WL 205684, at *9 (Del. Ch. Jan. 25, 2002) (stating that the shareholder Adlerstein was empowered to prevent its dilution through the new share issuances by "executing a written consent removing" either of the two directors approving the issuance from the board); Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407 (Del. 1985).

369. *See* Min, *supra* note 21 (manuscript at 46) (noting, on the other hand, that "it is not clear that it would apply to every controlling shareholder where dual-class stock is involved" and arguing that, given the preponderant governance purpose of the transaction, the business judgement rule should not apply).

370. *See* Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 601–02 ("Controllers can lose control not only when they sell their shares, but also when the company takes action — like issuing new shares — that dilutes the controllers' holdings.").

371. *See* Lund, *Nonvoting Shares*, *supra* note 59, at 696–98.

undermining the position of the shareholders with voting shares — as is the case for controllers — frustrates this rationale. This Article does not intend to argue in favor of the dual-class share structures for public companies; however, should they be considered a problem, but the way to deal with it is not to empower managers to dilute the controller through strategic issuances.

A possible critique of the rule is that since large shareholders are deemed critical to avoid the dilution, they may oppose the issuance of new stocks in order to retain their influence should they be not willing to invest additional resources: this may lead to an underinvestment in the firm, preventing it from reaching its optimal capital structure.[372] The magnitude of this argument may be particularly strong in the case of firms with concentrated ownership structures. Namely, since this type of firm "bundles cashflow rights and control rights,"[373] the controller must subscribe the new shares in order to retain control of the firm, contrary to what happens in the firms adopting a dual-class structure. Notably, this rule does not necessarily result in a veto right of the controller, since a controlling minority shareholder (or de facto controller) may be deemed to have a controlling influence and still not prevail in the vote, having the transaction approved against her will and her fractional voting power and interest decreased. However, it must be acknowledged that in the majority of cases, the approval of the controller would be critical; therefore, she may successfully oppose an issuance that is in the best interests of the firm.[374] However, it must be noted how the same underinvestment issue may be even worse with the current allocation of powers. In fact, since large controllers are concerned with the dilution, they also need to feel fairly protected from it: a seminal comparative corporate law study claimed that freeze-out transactions should be endorsed, among other things, because controllers may have weaker incentives to "invest additional capital in positive net present-value projects if they are forced to

372. *See* Poulsen, *supra* note 97, at 152 ("It is hypothesized that firms in which the largest shareholder would lose more influence in an equity increase have smaller equity increases and lower investments."); *see also* Kahan & Rock, *Index Funds and Corporate Governance*, *supra* note 84, at 50 (expressly mentioning the case of the issuance of new voting shares).

373. *See* Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 592 (suggesting that this bundling feature makes the concentrated ownership structure the middle-ground alternative to respectively dual-class and dispersed ownership structures, which may solve the agency issues of the two extreme structures).

374. *But see* Goshen & Hamdani, *Majority Control and Minority Protection*, *supra* note 21, at 454–55 (explicitly addressing a similar case and arguing that, in order to preserve the controller's ability to pursue "idiosyncratic vision" and her right to make managerial decisions — absent controller's consent — a dilution should not occur even if it is in the best interests of the corporation, regardless of whether the compensation is fair).

share their returns with minorities."[375] The argument should be transposed, and is even stronger, to the opposition to new equity issuances since the controlling shareholder, rather than being only prevented from increasing her participation in the company (as it would happen were the freeze-out not allowed), would face the risk of a significant decline in her fractional stake in the firm at managers' will.

On a practical note, the outcome of *CBS v. NAI* would not be significantly different under the proposed framework since the order against the shareholder was denied.[376] However, some differences appear. First, the controller achieved her goal, but the scope of her efforts was not tailored to the issuance: the move was an amendment to the corporation's charter, strengthening the approval requirements applicable to any dilutive issuance and, as such, it was effective but not narrowed.[377] Second, while the case eventually settled,[378] the new rule clarifies the allocation of powers between shareholders and managers in favor of the former. Third, the shareholders' vote is consistent with the above-mentioned deference of Delaware courts to the assessment of the financial markets and its increasingly sophisticated players.[379] To this extent, the same reputational and market-oriented arguments that made some minority shareholders' campaigns in controlled companies effective[380] may also deter the controller from abusing her powerful voting rights, therefore limiting the risk that she vetoes appropriate issuances.

The majority of this Section dealt with the hypothesis of equity issuances diluting the controller. However, as mentioned, the same process applies to the case of the controller participating pro-rata to the transaction, which is subject to the plain shareholders' vote that the controlling shareholder's voting power massively influences. Arguably, the controller-manager should be entrusted with the business decisions[381] and this issuance —

375. Rock et al., *Fundamental Changes*, *supra* note 37, at 174.

376. *See* CBS Corp. v. Nat'l Amusements, Inc., No. 0341-AGB, 2018 WL 2263385, at *1 (Del. Ch. May 17, 2018).

377. *See id.* at *2 ("NAI had executed and delivered consents to amend CBS's bylaws to, among other things, require approval by 90% of the directors then in office at two separate meetings held at least twenty business days apart in order to declare a dividend . . . .").

378. *See supra* Part I.

379. Goshen & Hannes, *The Death of Corporate Law*, *supra* note 79, at 289.

380. *See* Lund, *Nonvoting Shares*, *supra* note 59, at 742 (reporting cases in which the public pressures of minority investors resulted in the controller adopting a governance change, including the abolition of dual-class structures).

381. For a perspective where the controlling shareholder is pursuing its idiosyncratic vision, see Zohar Goshen & Assaf Hamdani, *Corporate Control and the Regulation of Controlling Shareholders*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS

reasonably lacking any target with regard to the governance of the issuer — genuinely falls in this category.[382] Also, as explained in the previous Section, this case represents the proper solution for a controller hoping that the firm raises additional capital to take advantage of a business opportunity. Here the cornerstone of the overall rule lies: all shareholders are entitled to exercise their voting right regardless of their status (either controller or minority), and there is enhanced protection for the minority shareholders when the controller favors a corporate governance change. However, should the transaction be only a business decision, the impact of the minority's votes in a controlled firm is likely to prove to be trivial.[383]

VI. CONCLUSION

The claim of this Article is to empower shareholders of public corporations with a voting right in new share issuances. The proposal lies in the massive impact that the issuance of new shares may have on the corporate governance of the public firm. The proposal enhances the shareholders' powers, seeks to limit these corporate governance impacts, and restates the notion of new share issuance mainly as a corporate finance transaction. Namely, the reduction of the managers' flexibility in affecting the ownership structure of the firm also prevents several abuses of the equity issuances when they are not necessary from a business perspective. In fact, in addition to the explained benefits of addressing the shareholder-manager and the majority-minority conflicts, the proposed framework also reduces the distortions that may occur in connection with a decision to issue new shares. In fact, on one side, it limits new share issuances only to the cases where the firm genuinely needs to raise additional capital or, alternatively, a reasonable weighted majority of the shareholders agree with the decision to affect the

23, 30–31 (Luca Enriques & Tobias H. Troger eds., 2019), which explains how asymmetric information and differences of opinion might lead to a different outcome if the controller is entrusted with the decision or only outsider investors are. Note that — with reference to *supra* notes 75–77 and accompanying text — in this scenario, the controller reasonably falls among the managers of the firm, who are reasonably entrusted with the business decisions.

382. *See* Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 607 (applying a similar reasoning to distributions and noting that "[a]ny rule that would try to scrutinize pro rata dividend distributions would necessarily interfere with the controller's management rights and her ability to secure her idiosyncratic vision"); *see also* Min, *supra* note 21 (manuscript at 45) (strongly arguing for a different treatment between pro-rata and non-pra-rata transactions, although in the context of the dividends issuance).

383. Lipton, *supra* note 156, at 1988 (noting that in the case of a controller with a small stake, the benefit of MoM is trivial and following this line of reasoning, a minority controller may be defeated regardless of her position).

ownership structure. On the other side, it eliminates the incentives of the managers to use alternative tools should the equity issuance be needed, given that their purpose to keep authorized, but not issued shares, available for strategic issuances would be frustrated by a shareholder vote on any equity issuance.