RESURRECTING RULE 14A-11: A RENEWED CALL FOR FEDERAL PROXY ACCESS REFORM, JUSTIFICATIONS AND SUGGESTED REVISIONS

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"Failure is only the opportunity more intelligently to begin again."

-Henry Ford[1]

I. INTRODUCTION

In the modern corporation, investors provide a company capital in exchange for an ownership interest and the right to elect directors to the company's board. The board of directors is charged with the corporation's management. The board delegates operational control of the corporation to managers it selects. Thus, the board's primary function is to serve the best interests of shareholders by selecting a CEO and supervising the CEO's performance.[2] When shareholders become dissatisfied with management and the board, they may either sell their shares, exercise

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1. HENRY FORD, MY LIFE AND WORK 10 (Project Gutenberg Ass'n, 10th ed. 2005), *available at* http://manybooks.net/titles/fordhenryetext05hnfrd10.html.

2. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 679–80 (2007). "The board selects the CEO and other top executives. The board sets the executives' compensation arrangements and thereby shapes their incentives. After selecting and hiring executives, the board is supposed to monitor their strategy and performance, replacing them if necessary." *Id.*

their right to vote to influence governance practices, or oust the board. This structure exists due to state corporation law and private ordering.[3]

As the preceding paragraph suggests, this structure results in a separation of ownership and control. While this separation allows publicly-traded corporations to amass huge sums of money,[4] it also gives rise to what is commonly known as the "agency problem." The agency problem can be expressed by the following question: How can the owners of a corporation, who do not control day-to-day operations, ensure that the non-owner managers charged with this responsibility act in the owners' best interest? As Adam Smith recognized in 1776, managers who are tasked with overseeing "other people's money . . . cannot well be expected [to] watch over it with the same anxious vigilance with which . . . [they would] watch over their own."[5]

The agency problem is not merely theoretical. Between 1984 and 1995, former Chairman and CEO Michael Eisner led the Walt Disney Company ("Disney") out of relative stagnation and into what has been described as the "Disney Renaissance."[6] His success did not last. In 2005, after fighting shareholder litigation in connection with his disastrous and expensive attempt at grooming a successor, a string of poor investment decisions and managerial failures,[7] a public campaign against him by

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3. Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1134 (1993). Delaware corporation law provides a good example of how state law creates this structure. Under Delaware's Code, "an annual meeting of stockholders shall be held for the election of directors on a date and at a time designated by or in the manner provided in the bylaws." DEL. CODE ANN. tit. 8, § 211(b) (2013). The board of directors, in turn, is given the authority to manage the "business and affairs" of the corporation. DEL. CODE ANN. tit. 8, § 141(a) (2013). Director duties are largely "administrative, and relate to supervision, direction and control" after details of the business have been "delegated to inferior officers, agents and employees." Cahall v. Lofland, 114 A. 224, 229 (Del. Ch. 1921), *aff'd*, 118 A. 1 (Del. 1922). Although state law dictates that shareholders elect directors, and directors manage the company's "business and affairs," the details of how this occurs are left to corporations through private ordering. This is why state corporation law is considered "enabling": State law provides default rules which can be modified by corporate actors to suit their needs.

4. JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 3–4 (Princeton Univ. Press 2008).

5. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 606–07 (Pa. State Univ., Elec. Classics Series ed. 2005).

6. Daniel Gross, *The Louse in the Mouse House: Why Disney's Michael Eisner Should Be Fired*, SLATE (Aug. 6, 2002, 6:48 PM), http://www.slate.com/articles/business/moneybox/2002/08/the_louse_in_the_mouse_house.html; Claudia Puig, *"Waking Sleeping Beauty" Documentary Takes Animated Look at Disney Renaissance*, USA TODAY (Mar. 25, 2010), http://usatoday30.usatoday.com/life/movies/reviews/2010-03-26-beauty26_ST_N.htm.

7. Gross, *supra* note 6.

former board member and shareholder Roy E. Disney,[8] and a 2004 director election where he received withhold votes from a historic 43% of shareholders,[9] Eisner left in disgrace. So, how did Eisner perpetuate himself as Chairman and CEO through a decade of decline between 1996 and 2005, all the while destroying hundreds of millions of dollars in shareholder value?[10]

Eisner was able to stay in power against all odds because Disney's board of directors was woefully inadequate in monitoring the man they were charged with managing.[11] The board included Eisner's personal lawyer, his friends, the principal of his children's school, his architect, and the president of a university Eisner had donated significant money to.[12] The Disney board had the notable distinction of being named the worst board in America in 1999 and in 2000.[13] Unfortunately, it took years of shareholder litigation and revolt before the board finally took action by separating the Chairman and CEO positions, and replacing Eisner with Robert Iger.[14] The change in management led to Disney's recent record-setting profits and share prices.[15]

However, the vestiges of Disney's troubled past linger. Disney's board recombined the Chairman and CEO positions for Iger and approved a massive compensation package which failed to tie Iger's pay with performance, much to the chagrin of shareholders.[16] Although the

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8. Mikey Walters, *Roy Disney Ends Save Disney Campaign*, DISNEY BLOG (Jul. 8, 2005), http://thedisneyblog.com/2005/07/08/roy_disney_ends.

9. Paul R. La Monica, *Eisner Out as Disney Chair*, CNNMONEY (Mar. 4, 2004, 10:54 AM), http://money.cnn.com/2004/03/03/news/companies/disney/index.htm.

10. One journalist commented: "Most of the media bosses who survive—Rupert Murdoch at News Corp., Sumner Redstone at Viacom, and Charles Dolan at Cablevision—can't be fired because they essentially own the companies. And then there is Disney's Michael Eisner, who survives against all odds, all explanation, and all commons sense." Gross, *supra* note 6.

11. In *In re Walt Disney Co. Derivative Litigation*, Chancellor William B. Chandler noted the "stark" contrast between ideal corporate governance practices and those employed by Disney: "[H]er testimony clarified how ornamental, passive directors contribute to sycophantic tendencies among directors and how imperial CEOs can exploit this condition for their own benefit[.]" 907 A.2d 693, 741 n.373 (Del. Ch. 2005) (discussing Professor Deborah DeMott's testimony during trial).

12. JOHN GILLESPIE & DAVID ZWEIG, MONEY FOR NOTHING: HOW CEOS AND BOARDS ENRICH THEMSELVES WHILE BANKRUPTING AMERICA 90 (Free Press 2010).

13. *Id.*

14. David Lieberman, *Will Disney Shareholders Challenge Iger Tomorrow?*, DEADLINE (Mar. 5 2013, 4:57 PM), http://www.deadline.com/2013/03/disney-shareholders-meeting-investor-rights-bob-iger-corporate-governance-policies.

15. *Id.*

16. *Id.*

company is performing admirably again, many of the problems which plagued the company and led to the Eisner debacle are being resurrected.

The Disney case is an example of corporate governance at its worst. It illustrates how a company may perform well despite a lack of good governance, but how that performance is unsustainable without it. Disney begs the question: Would things have turned out differently if shareholders could have nominated their own director candidates rather than relying on a largely precatory "withhold" vote against the incumbents?

In 2010, the U.S. Securities and Exchange Commission (the "SEC") adopted shareholder proxy access Rule 14a-11 ("the Rule"),[17] which presented just such an option for shareholders. The Rule allowed shareholders, subject to various limitations, to require a company to include in its proxy materials the shareholders' nominees for election to the company's board of directors. By allowing shareholders to include their nominees on a company's own proxy statement, the shareholders would have avoided significant expense. This would have encouraged shareholders to take a more active role in monitoring boards of directors, as well as pressuring incumbent directors to act as better fiduciaries. However, the Rule was invalidated less than a year later by the D.C. Circuit for the SEC's alleged failure to perform an adequate cost-benefit analysis.[18] In hindsight, the Rule's invalidation may have been a blessing in disguise. The SEC's Adopting Release regarding Rule 14a-11 was wrought with compromises and ambiguity which severely limited its effectiveness in achieving its goal of facilitating shareholder proxy access. But, the Rule's problems do not detract from the SEC's noble intentions of improving corporate governance. The Rule, albeit with significant revision, presents a very real and powerful tool for creating stronger boards of directors, and through it, improved shareholder value. Furthermore, statements made by SEC Chairman Mary L. Schapiro after the Rule's invalidation

17. 17 C.F.R. § 240.14a-11 (2010), *invalidated by* Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011). The current Code of Federal Regulations omitted the rule entirely after it was invalidated. The remainder of this Note will refer to the SEC's adopting release, Facilitating Shareholder Director Nominations, Fed. Reg. 56,668, 56,677–93 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249) [hereinafter Adopting Release].

18. *Business Roundtable*, 647 F.3d at 1148–49.

show that there is still sufficient will within the SEC to reattempt a federal proxy access rule:

> I firmly believe that providing a meaningful opportunity for shareholders to exercise their right to nominate directors at their companies is in the best interest of investors and our markets. It is a process that helps make boards more accountable for the risks undertaken by the companies they manage. I remain committed to finding a way to make it easier for shareholders to nominate candidates to corporate boards.
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> At the same time, I want to be sure that we carefully consider and learn from the Court's objections as we determine the best path forward. I have asked the staff to continue reviewing the decision as well as the comments that we previously received from interested parties.[19]

The agency problem, corporate governance, and the debate over proxy access have implications which extend far beyond any one company. These issues played a significant role in the financial crisis of 2008.[20] Corporations have become increasingly interconnected—both domestically and internationally—heightening the call for more rigorous monitoring of boards of directors and managerial risk-taking.[21] Gone are the days where the fall-out from the failure of one corporation was limited to a single company and its shareholders. Although proxy access is by no means a panacea to the present and future problems faced by our nation's economy, it represents one of many steps towards creating a stronger and more robust future.

This Note advocates revisiting Rule 14a-11. It also suggests several significant revisions to the Rule which would improve its effectiveness as a corporate governance tool, addresses many of the Rule's criticisms, and allows the SEC to perform a stronger cost-benefit analysis. Part II of this Note begins by providing an overview of the role of shareholder voting in corporate governance and the two primary mechanisms shareholders use

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19. Press Release, U.S. Securities and Exchange Commission, Statement by SEC Chairman Mary L. Schapiro on Proxy Access Litigation (Sept. 6, 2011), *available at* http://www.sec.gov/news/press/2011/2011-179.htm.

20. *See generally* Grant Kirkpatrick, The Corporate Governance Lessons from the Financial Crisis, FIN. MARKET TRENDS, Jul. 2009, *available at* http://www.oecd.org/finance/financial-markets/42229620.pdf (analyzing the impact that ineffective corporate governance had in causing or contributing to the financial crisis).

21. *Id.* at 4–14.

to discipline underperforming boards and management: hostile tender offers and proxy contests. It concludes that proxy contests are the most attractive mechanism for accomplishing effective board oversight. It then goes on to give a brief summary of Rule 14a-11 and its history. Part III acknowledges and addresses criticisms surrounding the Rule. Part IV establishes a framework for analyzing the Rule and the proposed revisions to it. Part V argues for several revisions to the Rule and discusses how those revisions improve upon it. Part VI discusses how the revisions could impact a future SEC cost-benefit analysis. Part VII briefly concludes.

II. BACKGROUND

In decades past, a large corporation's shareholder base was comprised of diffuse and dispersed investors with relatively small stakes. In the 1960s, 84% of all publically-traded stocks were held by physical persons.[22] More recently, however, corporate stock has been increasingly aggregated into the hands of institutional investors.[23] In 2009, over 70% of shares of the largest one-thousand companies were held by these institutions.[24] This trend has placed tremendous shareholder voting power into the hands of institutions that have the resources and sophistication necessary to monitor and discipline boards of directors: resources and sophistication which individual "lay" investors lack. The rise of institutional investors has set the stage for holding underperforming corporations accountable through shareholder voting and the market for corporate control.

A. The Market for Corporate Control

The primary mechanism by which shareholders enforce their interests is the market for corporate control. The market for control is a market-driven process by which management can be ousted when the

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22. Serdar Celik & Mats Isaksson, *Institutional Investors and Ownership Engagement*, 2 OECD J. FIN. MARKET TRENDS 93, 96 (2013).

23. The term "institutional investor" is difficult to accurately define, but is broadly construed as an institution which manages and invests the money of others. *Id.* at 95–96. Examples include mutual funds, pension funds, private equity funds, sovereign wealth funds, etc.

24. BEN W. HEINEMAN, JR. & STEPHEN DAVIS, COMM. FOR ECON. DEV. & YALE SCH. OF MGMT, ARE INSTITUTIONAL INVESTORS PART OF THE PROBLEM OR PART OF THE SOLUTION? 9 (2011). A look at smaller segments of the 1,000 largest corporations (by market capitalization) show similar percentages of institutional investor ownership. 72.8% of the top 500 companies are held by these institutions, and 63.7% of the top fifty. *Id.*

company's performance deteriorates.[25] A shareholder's two options for expressing dissatisfaction—selling their shares or voting on various issues—directly and indirectly affect the market for control in two ways. First, when shareholders sell their shares en mass the stock price drops, exposing the company to a potential hostile tender offer.[26] Second, a shareholder's ability to vote on various issues directly and indirectly influences the market for control by potentially ousting incumbent board members through a proxy contest or by amending bylaws to increase the *threat* of a proxy contest. The market for corporate control not only serves as a mechanism for correcting poorly performing companies, but also provides a disciplinary force which encourages all publicly-traded corporations to maintain their performance.[27]

Both hostile tender offers and proxy contests have their respective advantages, disadvantages, and impediments. In the sections which follow, both of these mechanisms for changes in corporate control will be discussed.

1. Hostile Tender Offers

A tender offer is a public offer to buy a target company's shares directly from the corporation's shareholders at a substantial premium in an effort to take control of the company.[28] A "hostile" tender offer, for purposes of this Note, is an offer to assume control of the company against the will of incumbent management. Hostile tender offers are initiated by sophisticated and well-financed investors. These investors possess the resources necessary to find inefficiently managed companies, identify which of these companies can be turned around by displacing incumbent management, and create and implement a plan to improve the company's value after acquisition.[29] Also, hostile tender offers often present shareholders with a clearer and simpler choice when compared to a proxy contest. Whereas shareholders must evaluate and choose between the competency of incumbent directors and shareholder nominees in a proxy contest, a hostile tender offer simply presents shareholders with a choice between the current market price of their shares and the premium price offered by the bidder.[30] Finally, hostile

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25. MACEY, *supra* note 4, at 118–19.

26. Stephen M. Bainbridge, *Response to Increasing Shareholder Power: Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1736 (2006).

27. MACEY, *supra* note 4, at 120.

28. BLACK'S LAW DICTIONARY 1606 (9th ed. 2009).

29. MACEY, *supra* note 4, at 121.

30. *Id.*

tender offers—and friendly mergers and acquisitions for that matter—ordinarily involve parties with a significantly greater stake in the outcome of a change in control. As Professor Jonathan Macey notes:

> Potential acquirers making tender offers for a controlling block of a company's shares have enormous credibility because they are risking their own capital to acquire the controlling block. Having gained control of the company, tender-offerors stand to benefit by managing the business in such a way as to increase the value of their shares, and the shares of their fellow shareholders.[31]

Proxy contests, on the other hand, do not require any significant stake in the target company to launch.[32]

Tender offers have their limitations. The transaction costs involved in a hostile tender offer are much higher than the costs of a proxy contest.[33] While both have the ultimate goal of changing the control over the corporation, only hostile takeovers involve purchasing a controlling interest in the target at a premium.[34] Also, there are significant legal hurdles to hostile takeovers which have drastically reduced their effectiveness in providing a disciplinary effect on management. These legal hurdles stem from federal statutes, such as the Williams Act of 1968[35] and the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("Hart-Scott-Rodino"),[36] and state law.

Federal statutes such as the Williams Act and Hart-Scott-Rodino impede the market for control by delaying tender offers. A major factor which determines the likely success of a hostile takeover attempt is the speed with which a potential acquirer can act.[37] The Williams Act

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31. *Id.* at 120.

32. *Id.* at 121.

33. Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CALIF. L. REV. 1073, 1078–79 (1990).

34. *Id.* at 1078.

35. Pub. L. No. 90-439, 82 Stat. 454 (codified as amended in scattered subsections of 14 U.S.C. §§ 78m and 78n) (1968)). The Williams Act amended the Securities and Exchange Act of 1934, and was intended to insure that recipients of a tender offer would not be rushed or coerced into accepting the offer. 2 Edward N. Gadsby et al., *Federal Securities Act of 1934*, § 7A.03[1] (Matthew Bender & Co., Inc. 2008).

36. 15 U.S.C. § 1311–12 (2014). The purpose of Hart-Scott-Rodino was to give the federal government sufficient notification and time to review mergers for potential anticompetitive effects through amendments to the Clayton Act. 2 Byron E. Fox & Eleanor M. Fox, *Corporate Acquisitions and Mergers*, § 19.01 (Matthew Bender & Co., Inc. 2014).

37. 1 Byron E. Fox & Eleanor M. Fox, *Corporate Acquisitions and Mergers*, § 5E.04[2] (Matthew Bender & Co., Inc. 2014); *see also* MACEY, *supra* note 4, at 122.

requires that potential acquirers who put forth a tender offer[38] for more than 5% of a company's securities comply with various disclosure requirements.[39] These disclosures must be filed with the SEC and delivered to the target company using a Tender Offer Statement known as a Schedule TO.[40] Hart-Scott-Rodino requires that any person planning to acquire large blocks of shares in a company file notification with the Federal Trade Commission and abide by a waiting period before consummating the acquisition.[41] These statutes have "made it easier for target firm management to entrench themselves by giving them 'earlier warning' about an outside bid, as well as more time to resist."[42]

State law has contributed to the problem through various antitakeover laws and by allowing companies to adopt defensive measures through private ordering.[43] State enabling laws also severely limit the market for corporate control by allowing companies to adopt entrenchment devices such as classified boards, supermajority shareholder voting requirements, and shareholder rights plans. The mechanics of each of these devices will be discussed in greater detail later in this Note.[44] While the existence of these devices alone presents significant obstacles for potential acquirers, the courts have arguably compounded the problem by providing shareholders little protection

38. What constitutes a "tender offer" is not defined by the Act. However, the SEC, at the request of the District Court of the Southern District of New York, provided eight criteria for determining when a tender offer exists. Brascan, Ltd. v. Edper Equities, 477 F. Supp. 773, 791 (S.D.N.Y. 1979). The criteria were whether: (1) there is "active and widespread solicitation of public shareholders"; (2) "the solicitation is made for a substantial percentage of the issuer's stock"; (3) the offer involves "a premium over the prevailing market price"; (4) "the terms of the offer are firm rather than negotiable"; (5) "whether the offer is contingent on the tender of a fixed minimum number of shares"; (6) "whether the offer is open only for a limited period of time"; (7) "whether the offerees are subject to pressure to sell their stock"; and (8) "whether public announcements of a purchasing program . . . precede or accompany a rapid accumulation[.]" *Id.* at 791–92 (quoting the SEC's amicus curiae brief). The court went on to apply the criteria, but expressed reservations about its permissibility and desirability. *Id.* at 791. However, other courts have gone on to apply these factors. *See* Ludlow Corp. v. Tyco Laboratories, Inc., 529 F. Supp. 62, 67 (D. Mass. 1981); E. H. I. of Florida, Inc. v. Insurance Co., etc., 499 F. Supp. 1053, 1065 n.8 (E.D. Pa. 1980); Fulco v. American Cable Systems, Nos. 89-1342-S, 89-1380-S, 89-1389-S & 89-1422-S, 1989 U.S. Dist. LEXIS 16879, at *7 (D. Mass. Oct. 4, 1989).

39. 15 U.S.C. § 78n(2)(d). The company receiving the tender offer must also be subject to Section 12 of the Exchange Act to fall within the scope of the Williams Act amendments. *See* 17 C.F.R. § 240.14d-1.

40. 17 C.F.R. § 240.14d-3(a).

41. 15 U.S.C. § 18a.

42. MACEY, *supra* note 4, at 122.

43. *Id.* at 123–26.

44. *See infra* Part IV.A.

against entrenched management when faced with potentially desirable tender offers.[45]

In *Moran v. Household International*, the Supreme Court of Delaware held that a corporation's board of directors may unilaterally adopt a shareholder rights plan designed to prevent unsolicited tender offers.[46] The court further held that a company's board is subject to a heightened "business judgment rule" when litigation arises from the adoption of a shareholder rights plan.[47] However, this heightened standard of review has done little to protect shareholders from decisions made by directors. In *Paramount Communications, Inc. v. Time, Inc.*, the Supreme Court of Delaware declined to force the board of Time, Inc. to redeem its shareholder rights plan to allow Paramount to purchase 100% of Time's shares in an all cash tender offer.[48] The board of Time refused to redeem the shareholder rights plan because it was attempting to consummate a merger with Warner Communication, Inc. which, although financially a less attractive deal, would allow Time to retain its senior management team.[49] The board of Time feared that Paramount would not be so kind.[50] Ultimately, Time's board was able to show that it performed a reasonable investigation of Paramount's bid and was therefore justified in rejecting it, regardless of whether it was the best decision for shareholders.[51] The court noted: "Plaintiffs' position represents a fundamental misconception of our standard of review under *Unocal* principally because it would involve the court in substituting its judgment as to what is a 'better' deal for that of a corporation's board of directors."[52]

Moran and *Paramount* illustrate the inadequacy of relying on state law and the judiciary as a mechanism for preserving the market for

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45. *See* MACEY, *supra* note 4, at 124–26.

46. Moran v. Household Int'l, 500 A.2d 1346, 1351–54 (Del. 1985).

47. *Id.* at 1355–56. Ordinarily, the "business judgment rule" serves as a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith[,] and in the honest belief that the action taken was in the best interests of the company." *See id.* at 1356. The plaintiffs carry the burden of overcoming the presumption by showing "a breach of the directors' fiduciary duties." *Id.* However, when the business judgment rule is applied to the adoption of a defensive mechanism such as a shareholder rights plan, the initial burden lies with the directors to "show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed " and that the defensive mechanism was "reasonable in relation to the threat posed." *Id.* (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985)). The directors merely need to show that they performed a reasonable investigation in good faith to satisfy the burden. *Id.*

48. Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1149 (Del. 1989).

49. *Id.* at 1144–48.

50. *Id.* at 1148–49. "The board's prevailing belief was that Paramount's bid posed a threat to Time's control of its own destiny and retention of the 'Time Culture.'" *Id.* at 1148.

51. *Id.* at 1154

52. *Id.* at 1153.

corporate control, and through it, shareholder welfare. State enabling laws provide corporate managers tremendous latitude in operating and arranging the affairs of the corporation. Also, the Delaware Supreme Court was correct in pointing out that it is not the place of the courts to substitute their business judgment for that of a board of directors. The business judgment rule, while effectively insulating directors from liability for exercising poor judgment, serves a very real purpose. Directors should be free to take reasonable risks on behalf of the corporation without legal liability for failures. Otherwise, innovation and growth would be curtailed. Thus, the business judgment rule was created in order to encourage risk taking and prevent judges from interfering in matters with which they lack expertise.[53] Unfortunately, these same protections which serve to foster innovation, efficiency, and the corporate form can also provide a cloak which hides bad governance, self-interested decision making, and defeats the self-regulating nature of the market for corporate control.[54] This, combined with the effects of federal laws like the Williams Act and Hart-Scott-Rodino, has "effectively destroyed the hostile takeover[,]" the "most powerful corporate governance device in the shareholders' corporate governance arsenal."[55]

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53. *See* Ralph A. Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 NOTRE DAME L. REV. 456, 483–85 (1985). The business judgment rule has four primary justifications: (1) to provide reassurance for managers in making business decisions; (2) to encourage risk taking; (3) to prevent lay judges from meddling in corporate decision making; and (4) to discourage frivolous derivative lawsuits. *Id.*

54. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005). The court described Chairman and CEO Michael Eisner as "Machiavellian," *id.* at 760, and as having "enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom." *Id.* at 763. Chancellor William B. Chandler employed similar language regarding the rest of Disney's board. *Id.* at 760–71. However, the court's holding illustrates why the judiciary is not an adequate mechanism for enforcing good corporate governance:

> Are there many aspects of Ovitz's hiring that reflect the absence of ideal corporate governance? Certainly, and I hope that this case will serve to inform stockholders, directors[,] and officers of how the Company's fiduciaries underperformed. As I stated earlier, however, the standards used to measure the conduct of fiduciaries under Delaware law are not the same standards used in determining good corporate governance. For all the foregoing reasons, I conclude that none of the defendants breached their fiduciary duties or acted in anything other than good faith in connection with Ovitz's hiring, the approval of the OEA, or his election to the Company's presidency.

Id. at 772.

55. *See* MACEY, *supra* note 4, at 124, 126.

2. Proxy Contests

Luckily, tender offers are not the only mechanism for utilizing the market for corporate control. Under current state law and most corporate governing documents, shareholders have the right to nominate and vote for directors at a company's annual shareholder meeting.[56] This allows shareholders to effectively wrest control from the existing board, or at least influence it. However, due to the dispersed nature of the typical company's shareholder base, most shareholders cannot attend meetings and must therefore vote by proxy.[57] Since a shareholder voting by proxy is not present at the meeting to nominate and campaign for her choice of director, a "proxy contest" is the only alternative. Proxy contests are campaigns by one or more dissident shareholders in opposition to management where the nominating shareholder distributes proxy materials to other shareholders to solicit their votes.[58] Although proxy

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56. *See* Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1263–64 (2009) ("Encompassed in the shareholders' voting right is their right to nominate candidates for directors. Both directors and shareholders have the ability to nominate directorial candidates."). Shareholders may nominate candidates from the floor of the shareholders meeting. *Id.* at 1266 (citing FRANKLIN BALOTTI & JESSE FINKELSTEIN, DELAWARE LAWS OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 7.9 (4th ed. 2006)). Aside from nominations from the floor, under Delaware law the director nomination process, including any process by which shareholders may make nominations, is governed by the corporation's charter and bylaws. *See* Levitt Corp. v. Office Depot, Inc., C.A. No. 3622-VCN, 2008 Del. Ch. LEXIS 47, at *24–25 (Del. Ch. Apr. 14, 2008) ("Despite the role of nominations in giving substance to elections . . . [,] Delaware General Corporation Law . . . discusses or imposes limitations on the nomination process."). However, Delaware law does recognize that some access to the nomination process is necessary to give effect to shareholders' right to elect directors. Hubbard v. Hollywood Park Realty Enterprises, Inc., 1991 Del. Ch. LEXIS 9, at *18 (Del. Ch. Jan. 14, 1991) ("We rest our holding as well on the common sense notion that the unadorned right to cast a ballot in a contest for office . . . is meaningless without the right to participate in selecting the contestants."). Delaware courts have thus been "reluctant to approve measures that impede the ability of stockholders to nominate candidates." Harrah's Entm't, Inc. v. JCC Holding Co., 802 A.2d 294, 310 (Del. Ch. 2002). But, a company may restrict a shareholder's ability to nominate directors provided the restriction is written in the corporate charter or bylaws in "clear and unambiguous" language. *Harrah's Entm't, Inc.*, 802 A.2d at 310; *see also Levitt Corp.*, 2008 Del. Ch. LEXIS, at *11–18. If the language is ambiguous, the ambiguity is "resolved in favor of the stockholders' electoral rights." Openwave Sys. v. Harbinger Capital Partners Master Fund I, Ltd., 924 A.2d 228, 239 (Del. Ch. 2007).

57. A proxy is a shareholder's grant of authority to a third party to cast a vote on behalf of the shareholder. Fairfax, *supra* note 56, at 1264. Proxy voting has become necessary in the operation of the corporate form in order to secure sufficient shareholder presence to meet quorum requirements at shareholder meetings. Fisch, *supra* note 3, at 1135.

58. Warren S. de Wied, *Proxy Contests*, PRACTICAL LAW THE JOURNAL, Nov. 2010, at 32, 33.

contests can be initiated over a multitude of proposals and issues, only those seeking to replace incumbent members of a board of directors will be discussed in this section.[59]

Shareholders initiating a proxy contest may either attempt a "control contest" or a "short-slate contest."[60] In a control contest, the dissident shareholder nominates sufficient directors to constitute a majority, and therefore control, over a company's board.[61] In a short-slate contest, the dissident shareholder nominates only a few or one nominee in order to attempt to influence the existing board members.[62]

Proxy contests have become an alternative to hostile tender offers due to legal and private ordering impediments which have severely reduced the effectiveness of tender offers.[63] Proxy contests also present a significant advantage for shareholders in that they do not require the capital necessary to purchase all outstanding shares of a corporation.[64] In addition, proxy contests may be used to facilitate an eventual tender offer. Taking control of a company's board allows the acquirer to dismantle antitakeover devices prior to initiating an outright acquisition through a tender offer.[65]

Proxy contests offer several advantages over hostile tender offers. First, proxy contests involve lower transaction costs since they do not directly involve purchasing all outstanding shares of a corporation at a premium.[66] Second, proxy contests are not completely thwarted by antitakeover devices such as shareholder rights plans.[67] For example, in Delaware, a board of directors may not adopt a defensive mechanism or bylaw amendment which "inequitably manipulate[s] corporate machinery

59. Proxy contests can be over any issue or initiative which shareholders are entitled to vote upon. For example, shareholders may propose and campaign for bylaw amendments or rescind antitakeover provisions. Kenneth J. Bialkin, *Why, When and How to Conduct a Proxy Contest for Corporate Control*, *in* 5-66 SECURITIES LAW TECHNIQUES § 66.01 (2013).

60. Vyacheslav Fos, *The Disciplinary Effects of Proxy Contests* 8 (Jan. 2013) (unpublished manuscript), *available at* http://www.stern.nyu.edu/cons/groups/content/documents/webasset/con_039717.pdf. Short-slate contests may be initiated by choice or out of necessity. For instance, a dissident shareholder may be forced to run a "short-slate" of nominees if a company has a classified board.

61. *Id.*

62. *Id.*

63. *See supra* Part II.A.1; *see also* Bialkin, *supra* note 59, at § 1. Not only are proxy contests an alternative to tender offers, they are the only alternative in the market for corporate control. Bebchuk & Kahan, *supra* note 33, at 1075.

64. Bialkin, *supra* note 59, at § 1.

65. *See id.*

66. *See supra* Part II.A.1.

67. Stroud v. Grace, 606 A.2d 75, 91 (Del. 1992).

to perpetuate 'itself in office' and disenfranchise[s] the shareholders."[68] Finally, proxy contests do not suffer from a particular type of "free-rider" problem[69] associated with tender offers. A shareholder, knowing a change in control may increase share value, may refuse to tender her shares in the hope that the tender offer will nonetheless be successful and her shares will increase in value beyond the premium she was offered.[70] For obvious reasons, this type of free-rider problem does not occur in proxy contests. Shareholders, assuming they are well informed, will vote in favor of director nominees who will increase shareholder value since they have nothing to gain by voting against them.

A proxy contest is not without its disadvantages. Incumbent directors have significant advantages over outsiders, making winning a proxy contest difficult for dissident shareholders. For example, the incumbent board controls the timing of contests.[71] The board also charges the expense of running a campaign to the company, whereas dissident shareholders generally must pay their own expenses.[72] Moreover, the incumbents have greater access to shareholders and insights into issues most likely to appeal to particularly influential or important shareholder groups.[73] Finally, dissident shareholders must send out their own proxy

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68. *Id.* (quoting Schnell v. Chris-Craft Industries Inc., 285 A.2d 437, 439 (1971)). This tenent applies whether the defensive measure was legally possible or not. *Id.* However, it does not apply if the device is implemented through ratification by a "fully-informed majority" of shareholders. *Id.*

69. A "free-rider problem" refers to any situation where individuals within a population benefit from resources without paying for the cost of the benefit. *See* Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42, 42 (1980).

> In all but the smallest groups social choice takes place via the delegation of power from many to few. A fundamental problem with this delegation is that no individual has a large enough incentive to devote resources to ensuring that the representatives are acting in the interest of the represented. Since the representatives serve the Public Good, the social benefit to monitoring their activities is far larger than the private benefit to any individual. That is, the Public Good is a public good and each person attempts to be a free[-]rider in its production.

Id.

70. Bebchuk & Kahan, *supra* note 33, at 1078–79. This "free[-]rider problem" is an issue because the acquirer bears the full cost of the tender offer, but may only receive a fraction of the benefits due to pre-existing shareholders consuming a portion of the profit. Grossman & Hart, *supra* note 69, at 43. These shareholder hold-outs are "free riding" because they bear none of the costs involved in the transaction. This problem may reduce the number of tender offers which *should* occur but do not because they are not profitable to the acquirer. *Id.*

71. MACEY, *supra* note 4, at 120.

72. *Id.*

73. *Id.*

materials and ballots, separate from the company's proxy statement.[74] This reduces the effectiveness of the dissident shareholder's campaign, and may cause confusion among other shareholders.

Proxy contests can also present shareholders with a difficult choice. Unlike tender offers, where shareholders receive a premium for their shares regardless of how the new management team performs after the acquisition, proxy contests only lead to increased value if shareholders make the "right" choice.[75] Making this choice can be difficult. Although shareholders may be dissatisfied with the incumbents, the existing board of directors is at least a known evil. Dissident shareholders' nominees, on the other hand, are an unknown which may prove to be even worse.[76]

But, the most significant hurdle to successfully waging a proxy contest is the shareholders' inability to access a corporation's proxy statement.[77] A company is not required to include shareholder nominees for director on its proxy statements. Therefore, shareholders who wish to nominate and campaign for a director unsupported by the company's management must create and disseminate their own proxy statements at their own expense.[78] In addition to the costs of creating proxy materials, mailing them to shareholders,[79] and receiving them back, the nominating shareholder often must hire expensive proxy solicitors and other consultants in order to stand a chance of winning an election.[80] A nominating shareholder may also face the costs of defending against legal challenges to the shareholder's proxy statement mounted by the incumbents.[81]

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74. Fairfax, *supra* note 56, at 1264–65.

75. Conversely, shareholders may actually lose significant value by making the "wrong" choice.

76. Bebchuk, *supra* note 2, at 691–92; *see also* Utpal Bhattacharya, *Communication Costs, Information Acquisition, and Voting Decisions in Proxy Contests*, 10 REV. FIN. STUD. 1065 (1997) (finding that "bad" nominees hurt well-managed firms more than "good" nominees benefit if elected).

77. A proxy statement is a form which must be furnished to shareholders prior to a shareholder meeting where votes are to be solicited. 17 C.F.R. § 240.14a-3(a). This applies both to the company and any shareholders who wish to solicit votes for nominees for directors. *Id.*

78. Fairfax, *supra* note 56, at 1264–65.

79. Federal securities regulation requires registrants (companies subject to federal securities regulation) to provide their shareholder lists to any beneficial holder of securities entitled to vote. 17 C.F.R. § 240.14a-7(a). Alternatively, the shareholder seeking to disseminate proxy materials may require the company to send the materials to its shareholders, provided the shareholder pays the costs. *Id.*

80. Bebchuk, *supra* note 2, at 688–89.

81. *Id.* at 689. All of these costs can be quite significant. Professor Bebchuk, in the article just cited, uses the example of a proxy contest initiated by Red Zone LLC at Six Flags, Inc. Red Zone spent $850,000 in legal fees and preparation, printing and mailing

Although the costs of a proxy contest can pale in comparison to the capital required to initiate a tender offer, an understanding of the difference between the potential rewards under both mechanisms is necessary to appreciate why proxy contest costs are so significant. When an acquirer successfully purchases a company, it stands to reap 100% of any gains in the target company's performance.[82] A dissident shareholder, on the other hand, must share the gains with all other security holders.

A hypothetical may help to illustrate. Let us say that Company A has one million outstanding shares priced at $20 per share. Company B offers $30 per share, or thirty million dollars, in total in a tender offer. After successfully completing the acquisition, Company B is able to raise the value of Company A to $40 per share. This nets Company B a gain of ten million dollars. Thus, Company B can justify significant additional costs of completing the acquisition as long as those costs remain below ten million dollars. Compare this with a hypothetical Shareholder X who owns 5%, or one million dollars, of Company A's shares. Shareholder X, convinced that Company A is being mismanaged, initiates a proxy contest to change Company A's management. If Shareholder X is able to successfully replace the incumbent board and realize the same gains in Company A's share price ($40), the Shareholder stands to gain one million dollars.[83] The rest of the nine million dollar gain in Company A's value is shared with all other shareholders. Although the total gain in Company A's value is the same in both scenarios, Shareholder X can only justify proxy contest costs up to one million dollars.

Of the two mechanisms which comprise the market for corporate control, proxy contests present the greatest potential for providing the disciplinary force necessary to improve corporate governance. Both tender offers and proxy contests provide similar disciplinary effects, and both have their respective advantages and limitations. But, proxy contests prevail for a single, pragmatic reason: The legal changes necessary to make proxy contests effective are simpler and more likely to occur. In order to make hostile tender offers more effective, it would be necessary to federally preempt state antitakeover statues[84] and reverse

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fees. *Id.* at 688–89. The company spent an additional $2.4 million in investment banking fees, $950,000 in travel expenses, and $600,000 in hiring professional proxy solicitors. *Id.* at 689.

82. Performance gains may profit the acquirer through either an appreciation in stock value or cash flow from operations. The acquirer may not even be after performance gains. It may be purchasing the target company to compliment the acquiring company's existing operations. It may even be after particular assets, such as physical plants or patents.

83. ($40 x 1,000,000 shares) x 0.05 = $2,000,000.

84. *See supra* text accompanying notes 43–55.

decades of state common law.[85] Proxy contests and shareholder voting, on the other hand, already enjoy varying degrees of positive judicial deference.[86] This means that federal intervention in this arena would have minimal impact on our state enabling law model in other areas, relative to the disruption required to override state law surrounding tender offers.[87] Finally, an existing template for federal intervention has already been created by the SEC's 2010 Rule 14a-11. The Rule, with some necessary tinkering and rethinking, provides a very real possibility of revitalizing the role of the market for corporate control in improving corporate governance and performance.

B. Dodd-Frank and Proxy Access Reform, SEC's 2010 Rule 14a-11, and the D.C. Circuit's Invalidation of the Rule

On July 15, 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[88] in response to the 2008 financial crisis.[89] Among the voluminous changes implemented by Dodd-Frank was a small section which, for the first time, explicitly granted the SEC the authority to regulate proxy access.[90] One month later, the SEC adopted proxy access Rule 14a-11.[91] The Rule was short

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85. *See supra* text accompanying notes 43–55.
86. *See supra* note 56.
87. *See supra* notes 56, 59, 68.
88. Pub. L. No. 111-203, 123 Stat. 1376 [hereinafter "Dodd-Frank"] (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).
89. *Wall Street Reform: The Dodd-Frank Act*, WHITE HOUSE, http://www.whitehouse.gov/economy/middle-class/dodd-frank-wall-street-reform (last visited Feb. 23, 2014).
90. *See* Dodd-Frank, Pub. L. 111-203, § 971(a), 123 Stat. 1376, 1915 (codified as amended at 15 U.S.C. 78n(a) (2010)). The amendment added the following language:

> (2) The rules and regulations prescribed by the Commission under Paragraph (1) may include—
>
> (A) a requirement that a solicitation of proxy, consent, or authorization by (or on behalf of) an issuer include a nominee submitted by a shareholder to serve on the board of directors of the issuer; and
>
> (B) a requirement that an issuer follow a certain procedure in relation to a solicitation described in subparagraph (A).

Id.

91. Adopting Release, *supra* note 17, at 56,677–93.

lived. Less than a year later, on July 22, 2011, the D.C. Circuit invalidated the Rule in *Business Roundtable v. SEC*.[92]

Rule 14a-11 was struck down due to the unique level of judicial scrutiny the SEC's rulemaking has been subject to.[93] Ordinarily, governmental agency rulemaking receives significant deference.[94] If Congress has expressly delegated rulemaking authority to an agency, regulations issued by that agency may only be set aside by the courts if they are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[95] This standard "is narrow, and a court is not to substitute its judgment for that of the agency."[96] The agency need only "articulate a satisfactory explanation for its action" based on an examination of relevant data.[97] The court then must consider "whether the decision was based on a consideration of the relevant factors [Congress intended the agency to consider] and whether there has been a clear error of judgment."[98] The factors the SEC is required to consider are investor protection, efficiency, competition, and capital formation.[99] However, rather than defer to the SEC's conclusions regarding empirical data and theory, the court admonished the agency's choices and reliance

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92. Business Roundtable v. SEC, 647 F.3d 1144, 1156 (D.C. Cir. 2011). The SEC's 2010 Rule 14a-11 was not the first proxy access reform attempt the Commission embarked upon. *See* Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 EMORY L.J. 435, 440–47 (2012), for a history of the SEC's prior attempts at proxy access regulation.

93. *See* Anthony W. Mongone, *Business Roundtable: A New Level of Judicial Scrutiny and its Implications in a Post-Dodd-Frank World*, 2012 COLUM. BUS. L. REV. 746, 793–95 (2012) (arguing that the level of judicial scrutiny applied in *Business Roundtable* refused to defer to the SEC's choices and therefore the court substituted its own judgment for that of the agency).

94. *See generally* William N. Eskridge, Jr. & Lauren E. Baer, *The Continuum of Deference: Supreme Court Treatment of Agency Statutory Interpretations from Chevron to Hamdan*, 96 GEO. L.J. 1083 (2008) (surveying the various agency deference regimes put forth by the Supreme Court and suggesting various reforms); *see also* Leen Al-Alami, Comment, Business Roundtable v. SEC*: Rising Judicial Mistrust and the Onset of a New Era in Judicial Review of Securities Regulation*, 15 U. PA. J. BUS. L. 541, 545–46 (2013).

95. 5 U.S.C. § 706(2)(A) (2011).

96. Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983).

97. *Id.*

98. *Id.*

99. 15 U.S.C. §§ 78c(f), 80a-2(c) (2011). Both sections employ nearly identical language, requiring the SEC to consider, "in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." 15 U.S.C. §§ 78c(f), 80a-2(c). Section 78c(f) regards the regulation of securities generally, and § 80a-2(c) regards the regulation of investment companies. Rule 14a-11 impacted both. Adopting Release, *supra* note 17, at 56, 682–83 ("New Rule 14a-11 will apply to companies that are subject to the Exchange Act proxy rules, including investment companies registered under Section 8 of the Investment Company Act of 1940.").

on studies the court found unpersuasive.[100] It ultimately concluded that the SEC acted arbitrarily and capriciously and vacated the Rule.[101]

Although the merits of the decision and standard of review the court deployed is beyond the scope of this Note,[102] it illustrates the importance of developing a clear, targeted, and workable proxy access rule should the SEC attempt proxy access reform again. The mechanics of a new Rule 14a-11 are critical in developing and articulating a proper analysis of the costs and benefits that would survive judicial scrutiny.

C. A Brief Summary of the SEC's 2010 Final Rule 14a-11

Rule 14a-11 was adopted, as stated by the SEC, to "facilitate the effective exercise of shareholders' traditional state law rights to nominate and elect directors to company boards of directors."[103] Specifically, the Rule was intended to benefit shareholders or groups of shareholders with a "significant, long-term stake" by requiring corporations subject to the

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100. *See* Business Roundtable v. SEC, 647 F.3d 1144, 1150–54 (D.C. Cir. 2011). The SEC recognized that conflicting studies exist regarding the impact of increased shareholder proxy access on shareholder value. *Id.* at 1150. The SEC discounted those studies which raised concerns "because of questions raised by subsequent studies, limitations acknowledged by the studies' authors, or [its] own concerns about the studies' methodology or scope." *Id.* at 1151 (quoting Adopting Release, *supra* note 17, at 56,762–63). However, the court seemed to find that those discounted studies adequately countered those which shed positive light on shareholder involvement in the selection of directors. *Id.* ("In view of the admittedly (and at best) 'mixed' empirical evidence, we think the Commission has not sufficiently supported its conclusion that increasing the potential for election of directors nominated by shareholders will result in improved board and company performance and shareholder value.") (internal citations omitted).

101. *Id.* at 1156.

102. Many others have commented on the controversy the opinion has generated. *See, e.g.*, Grant M. Hayden & Matthew T. Bodie, *The Bizarre Law and Economics of* Business Roundtable v. SEC, 38 J. CORP. L. 101 (2012) (criticizing the rationale of the D.C. Circuit's decision); J. Robert Brown, Jr., *Shareholder Access and Uneconomic Economic Analysis:* Business Roundtable v. SEC (U. Denv. Sturm College of Law, Working Paper No. 11-14, 2011) (criticizing the court's "standard with respect to the applicable economic analysis), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1917451. As one commenter put it:

> There are many (and I am one) who, although believing the SEC acted unwisely in adopting proxy access, at least in the form of Rule 14a-11, are concerned about the high, nigh impossible, bar the Court set that could put in jeopardy most SEC rulemaking of any complexity or controversy.

Stanley Keller, *What Now for Proxy Access?*, HARVARD L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Aug. 18, 2011, 9:29 AM), http://blogs.law.harvard.edu/corpgov/2011/08/18/what-now-for-proxy-access.

103. Adopting Release, *supra* note 17, at 56,668.

Rule to include these shareholders' nominees on the company's own proxy materials.[104] The Rule could only be used by those without the intent to change control of the company[105] and was limited to the nomination of 25% or less of a company's board positions.[106] The Rule applied to all companies subject to the Securities Exchange Act proxy rules.[107] Companies could not "opt-out" of the Rule, either unilaterally or by shareholder vote.[108] States were also prohibited from modifying or exempting the Rule's application.[109]

In order to use the Rule to nominate director candidates, shareholders were required to meet certain criteria. First, a nominating shareholder must have beneficially owned[110] 3% of the voting power of all securities entitled to be voted on the election of directors.[111] In order to meet this requirement, shareholders were permitted to form a nominating "group" and aggregate their shares.[112] In calculating the percentage of voting power a shareholder or shareholder group owns, any shares sold short and any shares borrowed would be subtracted.[113] This was designed to prevent a shareholder with a hedged position from using the Rule, keeping with the SEC's intent of facilitating shareholders with

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104. *Id.* at 56,669.

105. *Id.*

106. *Id.* at 56,706.

107. *Id.* at 56,683–88. This included investment companies and smaller reporting companies. *Id.* The only exceptions were for foreign private issuers and "debt-only" companies "that are subject to the proxy rules solely because they have a class of debt securities registered under Section 12 of the Exchange Act." *Id.* at 56,686. Foreign private issuers were already exempt from the SEC's proxy rules, and were therefore also exempt. *Id.* at 56,683.

108. Adopting Release, *supra* note 17, at 56,679. Nor could a company adopt "alternative" processes or requirements which would have replaced the Rule. *Id.* A company and its shareholders could have created an alternative method for nominating directors, but those alternatives would be a separate route by which shareholders could make nominations. *Id.* at 56,678, 56,680.

109. *Id.* at 56,678. States could, however, effectively "opt-out" of the Rule if the state passed laws prohibiting shareholders from nominating candidates for the board of directors entirely. *Id.*

110. The Rule's definition of "beneficial owner" is a person with the power to vote the security and dispose of the security. *Id.* at 56,695. The definition mirrors that of 17 C.F.R. § 240.13d-3. However, it differs in that § 240.13d-3 defines beneficial ownership as including *either* voting power *or* investment power. 17 C.F.R. § 240.13d-3.

111. Adopting Release, *supra* note 17, at 56,690.

112. *Id.* at 56,674. The Rule also included an amendment to 17 C.F.R. § 240.14a-2 which exempts communications between shareholders for the limited purpose of forming a nominating group from the proxy solicitation rules. *Id.* at 56,725–27. This was intended to facilitate the formation of such groups. *Id.* at 56,725.

113. *Id.* at 56,695.

a significant "long-term stake."[114] Second, the nominating shareholder or group must have held the qualifying percentage of voting power continuously for at least three years to demonstrate long-term interest in the company.[115] Third, the nominating shareholder or group must not have held any securities with the purpose of changing control of the company.[116] In order to show a lack of such intent, the nominating shareholder would have had to file a certification to that effect.[117] As a further safeguard, the nominating shareholder or group would also be barred from running or participating in concurrent proxy contests.[118] Finally, the director candidate being nominated by the shareholder or group would have to meet any requirements set forth by applicable state or federal law[119] and the "objective criteria"[120] for independence of the national securities exchange or association rules applicable to the company.[121]

Upon satisfying these requirements, the nominating shareholder or group would then file a Schedule 14N with the company and the SEC.[122] The Schedule 14N would have contained the following disclosures regarding the nominating shareholders:

- The amount and percentage of voting power held by the shareholders;
- The length of time the securities have been held;
- Biographical information about the shareholders; and

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114. *Id.* at 56,695–96.

115. *Id.* at 56,697–98.

116. *Id.* at 56,699–700.

117. Adopting Release, *supra* note 17, at 56,699.

118. *Id.* at 56,700.

119. *Id.* at 56,702.

120. An "independent director" is one that has no connection to the company other than her position on the board. Independent directors presumably suffer from less conflicts of interest and are therefore more likely to pursue the interests of shareholders. Despite the term's prominence throughout corporate and securities law, there is no uniform definition of what constitutes "independence." Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 133 (2010). Many securities exchanges require that listed company boards be comprised of some percentage of independent directors, and provide rules for determining "independence." Some of these rules are clearly objective, and others are arguably subjective. *See* Adopting Release, *supra* note 17, at 56,703 n.358. The SEC appears to define "subjective criteria" as criteria which require a determination by the board of directors. *Id.* at 56,704. ("To the extent a rule imposes a standard regarding independence that requires a subjective determination by the board . . . this element would not have to be satisfied."). An example of a "subjective" criterion provided by the SEC is the New York Stock Exchange's rule that an independent director "has no material relationship with the listed company" as affirmatively determined by the board of directors. NYSE, INC., LISTED COMPANY MANUAL § 303A.02(a) (2013).

121. Adopting Release, *supra* note 17, at 56,703–04.

122. *Id.* at 56,675.

- Whether or not the candidates nominated satisfied the company's director qualifications.[123]

The following certifications, based on the nominating shareholders' knowledge after reasonable inquiry, were also required:

- That the nominating shareholders were not holding any of the company's securities with the purpose of changing control of the company;
- That the nominating shareholders satisfied the requirements of the Rule;
- That the nominees satisfied the requirements of the Rule.[124]

Finally, the nominating shareholders would have included a statement regarding the shareholders' intended ownership of the securities following the election[125] and a 500-word statement in support of their candidates.[126]

In addition to Rule 14a-11, the SEC also amended Rule 14a-8.[127] Rule 14a-8 requires companies to include various shareholder proposals in its proxy statements.[128] Prior to the amendment, companies could refuse to include any proposals which sought to create or alter procedures for the nomination of directors.[129] The amendment removed the restriction, allowing shareholders to propose amendments establishing or altering director nomination procedures and disclosure requirements through the company's governing documents.[130] Although Rule 14a-11 was invalidated, the amendment to 14a-8 survived.[131]

III. ADDRESSING THE CRITICISMS OF RULE 14A-11

Before delving into what a "new" Rule 14a-11 should look like, it is necessary to first acknowledge and address the various criticisms of the original Rule. These criticisms can be categorized as those involving: (1)

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123. *Id.* Although the shareholder's nominee must have met the "objective" independence criteria for whichever securities exchange the company is listed on, the nominee was not required to meet any criteria set forth in the company's own governing documents. *Id.* at 56,704–05.

124. *Id.* at 56,675.

125. *Id.* at 56,675–76. The statement would indicate whether or not the nominating shareholders intended to hold onto their shares after the election, contingent on their nominee being elected.

126. *Id.* at 56,676.

127. Adopting Release, *supra* note 17, at 56,730–33.

128. 17 C.F.R. § 240.14a-8 (2011).

129. Adopting Release, *supra* note 17, at 56,730.

130. *Id.*

131. *See* 17 C.F.R. § 240.14a-8(i)(8) (2011).

the Rule's potential costs on corporations; (2) the difficulty shareholders would face in utilizing the Rule; (3) the ambiguity between the stated purpose of the Rule and its construction; and (4) the strong inclination to allow the "market" to sort things out through private ordering. I will address each of these criticisms in turn within the sections that follow.

A. Costs of the Rule on Businesses: Economic Costs, Intellectual Costs, and Short-Termism

Several scholars and commenters to Rule 14a-11 opposed its adoption on the grounds of cost. These costs included: (1) the potential economic costs to the company of fighting additional frivolous proxy contests;[132] (2) the intellectual costs to boards of directors;[133] and (3) the costs of "short-termism."[134] These criticisms are partly in response to the Rule's construction as proposed by the SEC, and in part to reticence regarding increased shareholder proxy access in general. Issues of construction can be addressed through a better rule. Issues surrounding increased shareholder access as a general proposition require some logic and a review of available empirical evidence.

Of the three issues noted above, the costs a company may incur from fighting an increased number of proxy contests can be addressed almost entirely by designing an effective rule. Elaine Buckberg and Professor Jonathan Macey's report[135] regarding the Rule best summarizes the concern. Buckberg and Macey argue that by reducing the costs of getting a shareholder nominee on the ballot without reducing the costs of proxy solicitation,[136] the Rule would only attract shareholders who will make nominations but not expend the resources necessary to participate in proxy solicitation.[137] These nominees would likely be of questionable value. But, more importantly, the authors feel that the incumbent board

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132. *See, e.g.*, Barnard S. Sharfman, *Why Proxy Access is Harmful to Corporate Governance*, 37 IOWA J. CORP. L. 387, 402, 405–06 (2012); ELAINE BUCKBERG & JONATHAN MACEY, REPORT ON EFFECTS OF PROPOSED SEC RULE 14A-11 ON EFFICIENCY, COMPETITIVENESS AND CAPITAL FORMATION 7–17 (2009).

133. BUCKBERG & MACEY, *supra* note 132, at 9–13.

134. Letter from Alexander Cutler, Chair, Corporate Leadership Initiative, Business Roundtable, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission 5 (Aug. 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-267.pdf.

135. BUCKBERG & MACEY, *supra* note 132.

136. *Id.* at 8. Ordinarily, a nominating shareholder under the traditional proxy contest process bears the cost of creating and distributing its own proxy ballot. The Rule eliminates this cost by requiring the company to incorporate the nominating shareholder's proxy materials on the company's own proxy statement. However, the costs of mounting a campaign to solicit votes is left largely undisturbed.

137. *Id.*

would feel obligated to defend against the inferior nominees, compelled by fiduciary duty, regardless of the likelihood of success.[138] This would be an obvious waste of corporate resources and time. Also of concern are the potential motivations of these shareholders. They may be pursuing private benefits. For example, unionized employees may seek leverage during contract negotiations by threatening a proxy contest, or "politically motived managers of public pension funds [may] utilize corporate governance advocacy as a means to enhance their political ambitions."[139]

These lines of reasoning seem to forget—or at least unduly minimize—the economic stake shareholders are required to have in order to use the rule. As proposed, the Rule would have required between 1–5% ownership of the company's voting power.[140] The threat of losing substantial sums of money by launching a proxy contest that may harm the company if successful seems irrational.[141] Nonetheless, it does highlight an important consideration in designing a new Rule: How much of an ownership stake should be required to prevent frivolous or wealth-destroying proxy contests while still encouraging desirable and wealth maximizing ones?

As for the potential intellectual losses a board may suffer by being forced to work with dissident shareholder nominees, the evidence does not seem to support the claim. Some argue that empirical studies show that "when dissident directors win board seats, those firms underperform peers by 19 to 40%[.]"[142] They go on to argue that dissident shareholder nominees would upset the balance of skills and experience which company nominating committees strive to create.[143]

Though disrupting an incumbent board can upset the balance the company was attempting to create, it is this very "balance" that can be the source of governance failure. Furthermore, the empirical evidence is

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138. *Id.* Common sense would lead most to conclude that a company's board would expend little effort fighting inferior shareholder nominees who stand little chance of winning board seats. But, the authors argue that the board members' legally imposed fiduciary duty distorts this logic, compelling them to expend significant resources to ensure the shareholder nominees' defeat in order to avoid liability. *Id.*

139. Sharfman, *supra* note 132 at 402, 405.

140. *See* Adopting Release, s*upra* note 17, at 56,689.

141. To put it in perspective, the cost of a 5% reduction in stock value for an owner of 1% of General Motors Co., would cost the shareholder $26,945,000. It seems unlikely that any particular private benefit or special interest one might accrue would outweigh those sorts of losses.

142. BUCKBERG & MACEY, *supra* note 132, at 9 (citing David Ikenberry & Josef Lakonishok, *Corporate Governance Through the Proxy Contest: Evidence and Implications*, 66 J. BUS. 405, 433 (1993)).

143. BUCKBERG & MACEY, *supra* note 132, at 10.

not as conclusive as some make it out to be. First, the study cited used data regarding proxy contests from 1968 to 1988.[144] Much has changed since then, especially in regards to the level of sophistication and interest among institutional investors. Second, the authors of the study itself acknowledge the numerous interpretations their data may support:

> The evidence might be regarded as supporting Berle and Means's (1933) contention that proxy contests destroy value. However, this suggests that shareholders are not rational when they cast their proxies. It is also not clear why rational dissidents would engage in such costly fights. Alternatively, the results may be interpreted as evidence that investors, both dissident and passive shareholders, consistently establish overly enthusiastic expectations concerning future performance.[145]

The authors go on to say that other data within their results are "consistent with the market's having overly optimistic expectations for cases in which dissidents were successful."[146] Finally, more recent empirical studies suggest an entirely different picture.

For example, a 1998 study of 270 proxy contests between 1979 and 1988 found that proxy contests increased shareholder value in the aggregate.[147] Another study conducted by the Investor Responsibility Research Center Institute ("IRRC")[148] in 2008 looked at companies with "hybrid boards."[149] It defined a "hybrid" board as one where dissident shareholders were able to obtain one or more board seats through actual or threatened proxy contests.[150] The IRRC found that companies with "hybrid" boards, on average, outperformed their peers. Of the 60% of companies which outperformed their peers, they did so by an average of 21.5%.[151] Of the 40% of companies that underperformed their peers, they did so by an average of 12%.[152] Therefore, the improvement experienced

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144. David Ikenberry & Josef Lakonishok, *Corporate Governance Through the Proxy Contest: Evidence and Implications*, 66 J. BUS. 405, 410 (1993).

145. *Id.*

146. *Id.*

147. *See* Harold J. Mulherin & Annette B. Pulsen, *Proxy Contests and Corporate Change: Implications for Shareholder Wealth*, 47 J. FIN. ECON. 279, 280 (1998).

148. *See generally* CHRIS CERNICH ET AL., IRRC INSTITUTE, EFFECTIVENESS OF HYBRID BOARDS (2009), *available at* http://www.irrcinstitute.org/pdf/IRRC_05_09_EffectiveHybridBoards.pdf.

149. *Id.*

150. *Id.* at 29–30.

151. *Id.*

152. *Id.*

by firms which outperformed their peers outweighed the harm other firms experienced, resulting in a net benefit in the aggregate. It is also worth pointing out that the IRRC study did not use data between 1968 and 1978—as the older study had—and arrived at different results. This may indicate that the increased sophistication of shareholders (especially institutional investors), improvements in technology and the dissemination of information, and heightened disclosure requirements implemented by the SEC over the years have made shareholders more effective as monitors.

The final criticism that will be addressed in this section is the fear that the Rule would encourage short-termism. The theory goes that some institutional shareholders with short-term interests—such as hedge funds—will use the Rule to pressure boards to take actions that increase short-term gains in stock price at the expense of long-term value.[153] The concern appears to be mostly theoretical with little empirical evidence to support it.[154] In fact, a recent study conducted in 2009 found that institutional investors with short-term investment horizons seem to be better informed than other investors and better predictors of future returns.[155] The study also found no evidence that short-term institutional investors exerted pressure on companies to pursue short-term gains at the expense of long-term value.[156] The study's authors concluded that short-term institutional investors were actually better informed than long-term investors.[157]

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153. *See* BUSINESS ROUNDTABLE, DETAILED COMMENTS OF BUSINESS ROUNDTABLE ON THE PROPOSED ELECTION CONTEST RULES AND THE PROPOSED AMENDMENT TO THE SHAREHOLDER PROPOSAL RULES OF THE U.S. SECURITIES AND EXCHANGE COMMISSION 14–16 (2009) [hereinafter BUSINESS ROUNDTABLE COMMENTS], *available at* http://www.sec.gov/comments/s7-10-09/s71009-267.pdf. Examples of short-term strategies which critics fear include: stock repurchases, asset sales, increased reliance on debt, distribution of dividends, and under-investment in research and development. *Id.* These actions potentially draw capital away from investments which could lead to long-term growth.

154. *See* Fisch, *supra* note 92, at 463–64. "The empirical support for this conclusion is limited. Although corporate America has cited the short-termism of institutional investors as a basis for restricting shareholder power, there is little evidence that shareholders are able to convince managers to sacrifice long-term firm value in favor of short-term interests." *Id.*

155. Xuemin (Sterling) Yan & Zhe Zhang, *Institutional Investors and Equity Returns: Are Short-term Institutions Better Informed?*, 22 REV. FIN. STUD. 893, 895–96 (2009).

156. *Id.* "We find no evidence of long-run price reversal for stocks held or recently traded by short-term institutional investors, suggesting that our results cannot be explained by the short-term pressure hypothesis." *Id.* at 896.

157. *Id.* at 895–96. "We also find no evidence that either the holdings or trading by long-term institutional investors predicts long-run stock returns. This result is inconsistent

Even if short-termism were to become an issue, it would be short lived. Proxy contests are election campaigns after all, with both the nominating shareholder and the incumbents stating their cases to shareholders through their proxy materials. If an institutional shareholder pursued long-term value destroying actions at any given company through a proxy contest, future incumbents at other companies would be quick to make compelling arguments against them in future elections. Such a strategy would likely become detrimental to the institutional investor in the long run.

B. The Difficulty Shareholders Would Face in Using the Rule

Potential costs aside, many have also criticized the Rule's somewhat onerous requirements on shareholders. These critics point out that the 3% ownership threshold and three-year holding requirement would have made the Rule impractical for all but a small handful of investors.[158] As one scholar persuasively points out:

> Public pension funds, union pension funds, foundations, and the like virtually never hold as much as 3% of a company—holdings of even 1% are comparatively rare because such concentrated holdings increase the risk of a portfolio. Hedge funds often buy stakes of more than 3% but . . . are unlikely to meet the three-year holding period requirement. The only institutional investors that regularly hold 3% stakes for at least three years are mutual funds, and even then, only a small few funds are likely to achieve that ownership level for any given company.[159]

The SEC's own data painted a rather grim picture of the Rule's practicality as well. According to the SEC's findings, only 32% of large companies had at least one shareholder who met the 3% ownership and three-year holding requirements.[160] Similarly, only 33% of smaller companies had at least one shareholder who met the requirements.[161]

The ability—or lack of ability—shareholders may have in using the Rule is a product of policy choice, compromise, and construction rather than a fundamental flaw in proxy access generally. Therefore, any

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with the hypothesis that long-term institutions are better informed about long-run returns." *Id.* at 896.

158. *See, e.g.*, Fisch, *supra* note 92, at 463.

159. *Id.*

160. Adopting Release, *supra* note 17, at 56,691.

161. *Id.*

difficulties shareholders face in using the Rule can be corrected by revising the ownership threshold and holding period, or eliminating them altogether.

C. Ambiguity Between the SEC's Stated Purpose and the Rule's Construction

One scholar who was critical of Rule 14a-11, Professor Jill E. Fisch, recognized that the SEC's stated objectives and justifications for implementing the Rule did not coincide with the structure of the Rule and the various requirements the Rule imposed.[162] While this is a broader, higher-level criticism of the Rule, it is important to address because the issue helps shape the enforcement of future incarnations of the regulation and partially determines whether it will withstand judicial scrutiny. As previously mentioned, the SEC's stated purpose for implementing the Rule was to "facilitate the effective exercise of shareholders' traditional state law rights to nominate and elect directors to company boards of directors."[163] More specifically, the SEC sought to construct a Rule, which "functions, as nearly as possible, as a replacement for an actual in-person meeting of shareholders."[164]

However, many of the restrictions and requirements of the Rule were inapposite to that purpose. State law does not restrict nominations based on the quantity of shares held or the length of ownership.[165] The Rule also exempted communications pursuant to forming a nominating group from other proxy regulations, but failed to grant the same exemption for shareholders performing the same activities pursuant to state law or a specific company's nominating procedures.[166] As Professor Fisch aptly concluded:

> The SEC's effort to defend Rule 14a-11 as facilitating the exercise of state law rights was disingenuous. By specifying qualifications and criteria for the exercise of nominating power, Rule 14a-11 attempted to create a federal nominating power—a power far narrower than that granted to shareholders by state law . . . . Moreover, to the extent that shareholder nominating power is based on the power to elect directors, state law provides no basis

162. *See* Fisch, *supra* note 92.
163. Adopting Release, *supra* note 17, at 56, 668.
164. *Id.* at 56,670.
165. Fisch, *supra* note 92, at 454–55.
166. *Id.* at 448–49.

> for limiting such power to a lesser number of nominees than those upon whom the shareholders vote . . . .[167]

Even more confusing was the SEC's choice *not* to include improving corporate governance as a core purpose for implementing the Rule, and it was not given a great deal of attention.[168] What makes this omission so befuddling is that any economic benefit the Rule would have produced stems from the idea that increased shareholder access leads to improved performance through better governance.[169]

Such ambiguity is destructive and must be resolved if a future Rule 14a-11 is to be successful. Although stated purposes may not directly affect technical aspects of the Rule, ambiguity creates a basis for opponents to attack a rule in court. An unclear statement of purpose also affects the persuasiveness of the SEC's analysis on the Rule's impact and undermines future judicial and agency interpretation of the Rule's provisions. Thus, the SEC should simply drop the state law rhetoric and use improving corporate governance and corporate economic performance as its sole purpose in enacting a future Rule 14a-11. Professor Fisch is correct: The Rule creates a federal nominating power separate from any state law right. This should be embraced by the SEC and would enable it to properly justify its choice of requirements and restrictions. It would also provide the SEC with greater freedom in producing empirical data which supports the Rule without fear of contradicting its stated purpose.[170]

D. The Preference for Private Ordering

Of all the criticisms surrounding Rule 14a-11, the argument that private ordering[171] through state enabling laws is superior to a federally

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167. *Id.* at 454–55.

168. Improved corporate governance was, however, mentioned in passing as a potential benefit. Adopting Release, *supra* note 17, at 56,681; 56,761–63; 56,767; 56,773–74.

169. *See* Fisch, *supra* note 92, at 454.

170. A great deal of available empirical data and theory which supports proxy access focuses on institutional and activist investors rather than retail investors. The Rule's construction recognized this implicitly when it adopted large share ownership requirements. However, using this evidence undermines the stated purpose of facilitating shareholders' state law rights since it restricts its use to only a small few. If the Rule were framed solely as providing improved governance and economic benefits, this would not cause the sort of cognitive dissonance the original Rule created.

171. "Private ordering" is the sharing of regulatory authority with private actors. In a private ordering scheme, the government delegates the authority to regulate various activities to the private players participating in the activities. *See* Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 319 (2002).

imposed standard is the most important issue to address. Other criticisms, such as the difficulty shareholders would face in meeting the requirements for using the Rule, the Rule's costs, the potential for abuse, and others all refer to issues of statutory construction and feasibility. While these are critical considerations, the argument in favor of private ordering presents a far more fundamental question: Even if a "perfect" federal rule could be constructed, is it the best solution?

Several scholars[172] and many commenters to the Rule[173] advocate for abandoning any attempt to impose mandatory proxy access in favor of more modest rule changes that would facilitate private ordering, retaining the status quo.[174] The stated reasons[175] for taking this view are: (1) the current system works just fine;[176] (2) states compete for corporate charters which encourages efficient regulation while the federal government does not;[177] and (3) federal regulation inhibits "experimentation" with different regulatory regimes.[178] However, there is a significant flaw within these arguments which strongly suggests that federal intervention in the realm of shareholder proxy access is necessary: State law favors corporate management and shareholders have limited ability to bargain for better terms through private ordering.

The view that the status quo is superior to a federally imposed mandate is rooted in the belief that the most practicable method of operating a large business enterprise is through a centralized and

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172. *See, e.g.*, Fisch, *supra* note 92 (advocating for SEC rules which facilitate inclusion of shareholder nominees on a company's proxy statement, but leave it to the states to determine when shareholders ultimately have access); Sharfman, *supra* note 132 (advocating for abandonment of mandatory proxy access and a return to the status quo prior to the 2010 amendment of Rule 14a-8); Bainbridge, *supra* note 26 (advocating for the status quo); D. Gordon Smith et al., *Private Ordering with Shareholder Bylaws*, 80 FORDHAM L. REV. 125 (2011) (advocating amendments to the *Delaware Code* and SEC Rule 14a-8 to facilitate private ordering rather than a mandatory federal proxy access rule).

173. Ninety-four commenters to the rule favored abandoning Rule 14a-11, but approved amending Rule 14a-8 to allow shareholder proposals to amend corporate bylaws governing director nominations and the election process. Adopting Release, s*upra* note 17, at 56,731 n.678.

174. *See* Fisch, *supra* note 92. In the article, Professor Fisch advocates for an SEC rule requiring companies to "disclose in their proxy statements all properly nominated director candidates," whether those nominations come from management or shareholders. *Id.* at 495. This rule would defer to state law "the circumstances under which shareholders have the power to nominate director candidates." *Id.*

175. The three arguments presented are those which directly address why private ordering is potentially preferable to a federal mandate.

176. Bainbridge, *supra* note 26, at 1739–40.

177. Fisch, *supra* note 92, at 487–88.

178. *Id.* at 490–92.

essentially non-reviewable decision-making authority.[179] Since an expansion of shareholder voting rights would divest some of that authority, it would disrupt this theoretically efficient mechanism.[180] Therefore, it is argued that shareholder voting rights, along with other methods of holding a board accountable, should be constrained in order to preserve the value of authority.[181] In lieu of having shareholders police a company's board and management, the market is offered as the main source of disciplinary force.[182] Professor Stephen M. Bainbridge, a leading proponent of this view, notes that "[d]espite the alleged flaws in its governance system, the U.S. economy has performed very well."[183] He further notes that companies which reincorporate in Delaware, a champion of the private-ordering-through-enabling-laws model, experience positive cumulative returns.[184] He contends that if investors felt Delaware was leading a "race-to-the-bottom,"[185] they would dump the stock of firms relocating there.[186]

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179. Bainbridge, *supra* note 26, at 1750. Professor Stephen M. Bainbridge explains: "[S]hareholders lack incentives to gather the information necessary to participate actively in decision making." *Id.* at 1745. The cost to shareholders of becoming properly informed is significant. *Id.* Therefore, it is more efficient to have all relevant information collected in a central location, i.e., the board and management, who then acts upon the information. *Id.* at 1746. This logic works well when applied to the responsibilities of day-to-day operations and even overall corporate strategy, but seems to fall short in explaining why shareholders should be excluded from deciding *who* should be charged with these responsibilities.

180. *Id.* at 1750.

181. *Id.*; *see also* Stephen M. Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 785–90, 812 (2006) [hereinafter *Unocal at 20*].

182. Bainbridge, *supra* note 26, at 1736.

> The mechanism by which securities are priced ensures that the price reflects the terms of governance and operation offered by the firm. If those governance terms are unfavorable, investors will discount the price they are willing to pay for that firm's securities. As a result, the firm's cost of capital rises, leaving it, inter alia, more vulnerable to bankruptcy or hostile takeover. Corporate managers therefore have strong incentives to offer investors attractive governance arrangements[.]

Id. (internal quotation marks omitted).

183. *Id.* at 1739.

184. *Id.* at 1743.

185. Professor Bainbridge disputes the "race-to-the-bottom" theory in favor of the theory that state competition fosters more efficient regulation. *Id.* at 1742–43. The "phenomenon of state takeover regulation," according to advocates of the latter theory, is merely an outlier: "[A]dvocates . . . concede that state regulation of corporate takeovers appears to be an exception to the rule that efficient solutions tend to win out." *Id.* at 1742.

186. *Id.* at 1743. It should be noted that using Delaware as evidence that state enabling laws are preferable to federally imposed mandates in the realm of proxy access is not particularly illuminating. First, Delaware has a relatively weak antitakeover statute in relation to other states. Second, shareholders approve reincorporation to Delaware because it results in improved firm value, not necessarily because Delaware is more "shareholder

It must be stressed that proponents of this side of the debate do not advocate removing shareholders from the picture entirely.[187] Rather, due to the complexities and dynamic nature of economic realities, the argument is that private ordering through state enabling laws is better suited for striking the proper balance of power between management and shareholders.[188]

It is undeniable that private ordering is *usually* superior to federal mandates in accommodating and adapting to the rapidly changing economic, regulatory, and political landscape. But, in the context of shareholder proxy access, the view that the status quo of private ordering is preferable to federal intervention suffers from a fatal flaw: State law caters to corporate management.[189] Fortunately, the majority of state corporation laws govern issues where management and shareholder interests do not directly conflict. For example, matters such as formation, general corporate powers, board composition and responsibilities, classes

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friendly." Third, Delaware law provides many substantial advantages which benefit both management and shareholders mutually, irrespective of whether the state is "pro-management" or "pro-shareholder," such as "a specialized judiciary, its developed body of case law, and the network externalities associated with its law." Michal Barzuza, *Price Considerations in the Market for Corporate Law*, 26 CARDOZO L. REV. 127, 132 (2004). These competitive advantages are difficult to separate from the impact of Delaware law's protections or lack of protections for shareholders in determining the reasons why, in general, corporations and their shareholders decide to reincorporate in the state.

187. *See* Fisch, *supra* note 92, at 484–85. "Critically, to function well, corporate governance must maintain a balance between managerial and shareholder power. Excess managerial power increases managerial agency costs. Excess shareholder power creates inefficiency and may, in some cases, create intra-shareholder agency costs." *Id.* Professor Bainbridge also expresses some level of reservation regarding resistance to proxy contest reform, but ultimately dismisses it. *See* Bainbridge, *supra* note 26, at 1740.

188. Fisch, *supra* note 92, at 487–90.

189. Those who advocate for private ordering through state enabling laws do not inherently disagree with this notion. Both Professors Bainbridge and Fisch subscribe to the idea that state competition for corporate charters produces efficient results, oft described as a "race-to-the-top." Both "race-to-the-top" and "race-to-the-bottom" arguments are rooted in the belief that state law caters to corporate managers. Robert B. Ahdieh, *Trapped in a Metaphor: The Limited Implications of Federalism for Corporate Governance*, 77 GEO. WASH. L. REV. 255, 256–59, 267 (2009). However, "race-to-the-top" theory holds that managers participate in their own competition for scarce investment capital which leads to innovation and efficient results. *Id.* at 257–58.

> If *states* are competing in ways that advance the interests of *managers*, and *managers* are competing in ways that advance the interests of *shareholders*, the standard account implicitly suggests, we can simply drop managers out of the middle. With this bit of New Math, we arrive at the conventional wisdom of the modern literature, in which *states* compete in ways that advance the interests of *shareholders*.

Id. at 258.

of stock, and the scheduling of meetings and elections do not always directly address the balance of power between shareholders and managers.[190] The theory that state enabling law produces efficient results is premised on the idea that market forces influence management to adopt the "best" structures through private ordering. Assuming there is no significant shareholder dissatisfaction present when these matters arise, both shareholders and management have a mutual interest in finding an efficient means of formation, establishing a hierarchy of authority, and creating rules for the continued operation of a corporation through private ordering.

But, when there is an imbalance between the bargaining powers of parties with diverging interests, inefficient results often occur.[191] Such is the case with proxy access. Shareholders are at a significant informational disadvantage when compared to a company's board. They are also severely limited in their ability to bargain with management in developing a private ordering solution.[192] This, combined with a diffuse shareholder base and collective action problems, dissuades shareholders from voicing concern over inefficient or negative results of private ordering when performance and governance problems have yet to materialize. In other words, shareholders are likely to accept a suboptimal private ordering result as long as the company performs in

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190. Of course, these matters can and do affect shareholder voting power when abused. For example, a company's board may attempt to expedite or postpone shareholder meetings in an effort to entrench itself. *See* Kidsco, Inc. v. Dinsmore, 674 A.2d 483 (Del. Ch. 1995); Aprahamian v. HBO & Co., 531 A.2d 1204 (Del. Ch. 1987); Schnell v. Chris-Craft Indus., 285 A.2d 437 (Del. 1971). In all these cases, the incumbent board either postponed or expedited shareholder meetings in order to disrupt a proxy contest launched by dissident shareholders.

191. Race-to-the-top theory views state corporate law and judicial venues as commodities consumed by corporations. William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 640 (2006). The "market," then, takes care of the rest. *Id.* at 639–40. However, the law as product analogy works as a policy justification only when the regulating state provides a regulatory product that does not externalize costs on anyone other than the consuming corporation. *Id.* at 643. Meeting the qualification of controlling the externalization of costs "depends on the heroic assumption that shareholder and manager interests are always perfectly aligned, rendering irrelevant the mandated agenda control managers enjoy under the state system. Where, as with takeovers, interests do not stand aligned, the state system displays a structural defect." *Id.*

192. *See* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1407–20 (1985). Professor Brudney notes that investors are unable to negotiate the terms of the relationship between investors and management since shareholder power is largely limited to voting "yes" or "no" on management proposals and director nominations. *Id.* at 1411–16. Even the power of shareholder votes is severely limited by the lack of information available for shareholders to make informed choices. *Id.* at 1413–14.

the short term.[193] This explains why private ordering often produces efficient results, but also why shareholders may not resist private ordering results even when it does not. Thus, private ordering *usually* produces optimal results regarding issues where management interests align, or at least can coexist, with shareholder interests.

A prime example of an inefficient result of private ordering is the use of antitakeover mechanisms, such as shareholder rights plans, classified boards, and supermajority shareholder voting requirements.[194] There is strong evidence that these devices—especially shareholder rights plans and classified boards—reduce firm value.[195] These artifacts of private ordering, combined with state statutes which strongly favor management,[196] are illustrative of the deficiencies in the overzealous reliance on the state enabling law model. They also severely restrict the disciplinary effect of other market devices that objectors to federal regulation rely upon to hold directors accountable, such as hostile takeovers.[197]

Ultimately, competition between states results in laws which favor those able to form, reincorporate, or reallocate resources to the state, i.e. management. This creates an intrinsic defect in the state enabling law

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193. There is evidence to support this notion. A study by Bo Becker, among others, suggested that the "financial markets placed a positive value on shareholder access, as implemented in the SEC's August 2010 Rule." Bo Becker et al., *Does Shareholder Proxy Access Improve Firm Value?: Evidence from the Business Roundtable Challenge* 4 (Harvard Bus. Sch., Working Paper No. 11–052, 2012), *available at* http://www.hbs.edu/research/pdf/11-052.pdf. The study's authors then asked the question: "[I]f enhanced proxy access would have increased firm value, why didn't shareholders and managers find a way to privately agree on proxy access, without the intervention of the SEC?" *Id.* at 6. The authors speculated, based on their results, that "some friction prevents firms from achieving the optimal degree of shareholder democracy on their own." *Id.* This paradox is consistent with the notion that shareholders do not fight—through private ordering—for better results until significant problems arise which justify the costs of doing so.

194. *See infra* Part IV.A for descriptions of these devices and how they can reinforce poor company performance.

195. *See infra* note 209.

196. State antitakeover statutes are an example.

197. *See supra* text accompanying notes 43–55. Interestingly, Professor Bainbridge also advocates for limiting legal impediments which would constrain boards of directors from adopting antitakeover devices. *See* Bainbridge, *Unocal at 20*, *supra* note 181, at 807. This comports with his theory of director supremacy, but seems to leave little room for a mechanism for achieving any sort of director accountability. Others take a more nuanced view, recognizing the value of shareholder involvement as an accountability and error-correcting mechanism but prefer to leave regulation to the states and private ordering. *See* Fisch, *supra* note 92, at 484–94; *see also* Jill E. Fisch, Book Review, *The Overstated Promise of Corporate Governance*, 77 U. CHI. L. REV. 923, 934–35, 942–43 (2010) (reviewing JONATHAN MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKE (Princeton Univ. Press 2008)).

model which is unlikely to resolve itself.[198] Private ordering is therefore unlikely to produce optimal results regarding proxy access because the interests of management and shareholders conflict.[199] Even though investors desire greater access[200] and greater access has been correlated with improved firm value,[201] unless the imbalance between the bargaining power of shareholders and management is corrected, optimal private ordering cannot be achieved. Therein lies the dilemma: How can the imbalance be corrected if the very same imbalance inhibits shareholders' attempts to adjust the allocation of power through more favorable proxy access?

The answer is likely federal intervention. Federal agencies are not subject to the same competitive pressures which inhibit state legislatures.[202] This allows federal actors to consider opposing arguments

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198. *See generally* Bratton & McCahery, *supra* note 191.

> Because the market forces a state that actually competes to focus on the variables that influence incorporation decisions, there follows a concern for management preferences rather than shareholder value itself. Accordingly, nothing at the state level prevents suboptimal accommodation of management preferences respecting ex post affiliation terms and fiduciary standards.

Id. at 643–44.

199. State antitakeover statutes are the often cited poster child of the inefficiencies in the state enabling law model. *See* Bainbridge, *supra* note 26, at 1742. Though the author of this Note agrees with Professors Bainbridge and Fisch that state enabling law ordinarily leads to efficient results, antitakeover statutes are exemplary of the proposition that these laws fail when management's interests sufficiently diverge from those of shareholders.

200. A significant number of institutional investors wrote letters strongly in favor of Rule 14a-11 when it was proposed. *See, e.g.*, Letter from Jeff Mahoney, Gen. Counsel, Council of Institutional Investors, to Elizabeth M. Murphy, Sec'y, Sec. and Exch. Comm'n (Aug. 4, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-78.pdf; Letter from Abe Friedman, Global Head of Corporate Governance & Proxy Voting, Barclays Global Investors, to Elizabeth M. Murphy, Sec'y, Sec. and Exch. Comm'n, (Aug. 14, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-172.pdf; Letter from Ten Institutional Investors, to Mary L. Schapiro, Chairman, Sec. and Exch. Comm'n (Aug. 17, 2010), *available at* http://www.sec.gov/comments/s7-10-09/s71009-668.pdf; Letter from Anne K. Kvam, Global Head of Corporate Governance, Norges Bank Inv. Mgmt., to Sec. and Exch. Comm'n (Aug. 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-258.pdf; Letter from Joseph A. Dear, Chief Inv. Officer, CalPERS, to Elizabeth M. Murphy, Sec'y, Sec. and Exch. Comm'n (Aug. 14, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-259.pdf.

201. *See* CERNICH, *supra* note 148 (finding that boards where shareholders successfully nominated and elected one or more directors outperformed their peers); Mulherin & Pulsen, *supra* note 147 (finding that proxy contests increased shareholder value in aggregate); Fos, *supra* note 60 (finding that, as the likelihood of a proxy contest increases, the operating performance of the company improves).

202. Federal regulators are not heavily influenced by a need to compete for domestic corporate charters. Although they may experience pressure from lobbyists, they are nonetheless in a better position to weigh opposing arguments more fairly as opposed to

and interests without an implicit obligation to side with any one party. Federal regulators may also have greater access to expertise gained through the pooling of resources and information.[203] This can allow the federal government to create efficient rules in those instances where the states or private actors cannot.[204]

Furthermore, the evidence suggests that federal intervention in the arena of shareholder proxy access would not result in the disruption of our system of private ordering through state enabling laws.[205] Federal and state corporate laws have long coexisted harmoniously.[206] Federal intervention mandating shareholder proxy access would merely correct an imbalance that the markets and private ordering have thus far been unable to rectify. The states' ability to pursue enabling laws and compete for corporate charters—the fundamental underpinning of the private ordering model—would be undisturbed.

Finally, adopting a uniform default rule mandating shareholder proxy access may actually improve and protect private ordering. As those who oppose federal intervention point out, rulemaking efficiency can be enhanced by competitive pressures.[207] Ultimately, shareholders are the "market": Corporate stock is a commodity which shareholders consume. Therefore, properly constructed regulation which allows for greater shareholder influence is, in effect, a way to empower the market to promote efficiency. The status quo, when viewed from this perspective, is actually a hindrance to a properly functioning free market system. A

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state actors who are more inclined to categorically side with management interests. Another key difference for the SEC in particular is that undue pressure from interest groups is counterbalanced by unusually intense judicial review. *Cf.* Al-Alami, *supra* note 94 (analyzing the increasingly intense judicial scrutiny of SEC actions compared to the deference ordinarily given to other federal agencies).

203. Ahdieh, *supra* note 189, at 296.

204. The SEC also acknowledged this idea in adopting Rule 14a-11:

> [C]orporate governance is not merely a matter of private ordering. Rights, including shareholder rights, are artifacts of law, and in the realm of corporate governance some rights cannot be bargained away but rather are imposed by statute. There is nothing novel about mandated limitations on private ordering in corporate governance.

Adopting Release, *supra* note 17, at 56, 672.

205. *See generally* Bratton & McCahery, *supra* note 191. In this article, Professors Bratton and McCahery survey the history of interaction between state and federal corporate law and determine that the two have coexisted to be mutually beneficial. *Id.* The authors also present evidence that the federal government has little incentive to "micromanage" and give various examples of successful federal incursions into substantive corporate law. *Id.* at 650–74.

206. *See generally id.*

207. *See* Fisch, *supra* note 92, at 488–89.

federal rule mandating shareholder access would thus *improve* private ordering by increasing competitive pressure upon boards of directors. This would further motivate directors to adopt efficient rules. Increasing shareholder influence over corporations can also *protect* private ordering by eliminating the need for government regulation in other areas of corporate governance and the securities markets. A uniform expansion of shareholder power would allow investors to push for improved governance terms and increased investor protections when needed through private ordering. This alleviates the need for government regulation in these areas.[208]

For all of these reasons, federal intervention through a revamped Rule 14a-11 is the most pragmatic solution for achieving the necessary balance of power between shareholders and company management. Given the limitations of state law and private ordering, the status quo is not the answer.

IV. GUIDING PRINCIPLES AND A FRAMEWORK FOR ANALYSIS

In order to properly present and analyze potential revisions to Rule 14a-11, it is important to establish some of the governance "problems" the Rule is to address and build a framework for applying the revisions to these issues. The following sections will identify three devices which inhibit good governance, explore how a new Rule 14a-11 can address these issues, and describe a framework for analyzing revisions.

A. Management Entrenchment is Negatively Correlated with Firm Value

One of the core purposes of strengthening a shareholder's ability to nominate directors to a company's board is to combat entrenched management. Therefore, understanding the devices management uses to entrench itself is necessary in any discussion of Rule 14a-11. In this section, three of these devices will be briefly examined: (1) classified boards; (2) supermajority voting requirements for bylaw amendments; and (3) shareholder rights plans. These devices are of particular significance because they directly impede shareholders' ability to effect changes in a company's governance and performance. There is also no shortage of empirical evidence that these devices have a detrimental

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208. *See* Lucian A. Bebchuk, *Response to Increasing Shareholder Power: Reply: Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1789 (2006). "In the absence of shareholder power to initiate rules-of-the-game decisions, adoption of such constraint is unlikely without regulatory intervention. With shareholder power over rules of the game, such intervention could be unnecessary." *Id.*

effect on firm value and shareholder wealth.[209] They are also devices which Rule 14a-11, if properly designed, can help to overcome.

1. Classified Boards

A classified (staggered) board is one where the directors are divided into classes, usually three, with only one class standing for election each year.[210] The purpose of such an arrangement is to impede a shareholder's ability to gain majority representation on the company's board of directors, since only a minority of board positions are up for election each year.[211]

A company classifies its board through either provisions in the corporate charter or through bylaws.[212] If a company's governing documents do not provide for a classified board, it can only classify the board by amending its charter or bylaws with shareholder approval.[213] Classified boards disrupt the market for corporate control by facilitating the entrenchment of incumbent directors. In order for a dissident shareholder to take control of a classified board, the shareholder needs to run at least two proxy contests to gain a majority of seats.[214] When

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209. *See, e.g.*, James M. Mahoney & Joseph T. Mahoney, *An Empirical Investigation of the Effect of Corporate Charter Antitakeover Amendments on Stockholder Wealth*, 14 (Bureau of Economic and Business Research, Working Paper No. 91-0154, 1991) (finding that antitakeover devices have both positive and negative effects on shareholder wealth in takeover situations, but that the negative outweigh the positive); Lucian A. Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009) [hereinafter *What Matters*] (finding that classified boards, limitations on shareholder amendments, supermajority voting requirements, shareholder rights plans, and "golden parachutes" have negative effects on overall firm value evidenced by lower Tobin's Q values); Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) [hereinafter *Staggered Boards*] (finding that the presence of a classified board has negative effects on shareholder wealth in takeover situations); Michael D. Frakes, *Classified Boards and Firm Value*, 32 DEL. J. CORP. L. 113 (2007) (finding that, on average, classified boards have a negative effect on overall firm value); Olubunmi Faleye, *Classified Boards, Firm Value, and Managerial Entrenchment*, 83 J. FIN. ECON. 501 (2007) (finding classified boards have a negative effect on overall firm value using Tobin's Q).

210. Mahoney & Mahoney, *supra* note 209, at 20.

211. *Id.*

212. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(d) (2013).

213. Corporate charter amendments require both shareholder and board approval. *See* John C. Coates, IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CALIF. L. REV. 1301, 1306 (2001). Bylaws, on the other hand, can be unilaterally amended by the board in some circumstances. However, state law ordinarily requires shareholder approval for bylaw amendments that seek to classify a board. *See* DEL. CODE ANN. tit. 8, § 141(d) (2013); N.Y. BUS. CORP. LAW § 704(a) (Consol. 2013).

214. Bebchuk et al., *Staggered Boards*, *supra* note 209, at 899.

combined with a shareholder rights plan, which will be discussed shortly, the antitakeover effects of both are amplified.[215] With both devices in place, a dissident shareholder essentially must win three battles over two to three election cycles: two proxy contests to replace a sufficient number of directors in order to redeem the shareholder rights plan, and a third to effect a successful tender offer.

2. Supermajority Voting

Supermajority voting provisions in a company's governing documents typically require that various proposals or company actions achieve between 66% and 80% shareholder approval to implement.[216] This impedes the ability of shareholders to amend bylaws or approve beneficial mergers. In the context of proxy access, a supermajority voting requirement to pass bylaw amendments which seek to change a company's board structure, nomination, or election processes makes it more difficult for shareholders to affect how the company is managed. Moreover, it can be used to block mergers and acquisitions of the company.[217] It also can strengthen other management entrenchment devices, such as classified boards.

Unlike classifying a board, supermajority voting requirements can be adopted unilaterally by the board of directors through bylaw amendments.[218] If a supermajority voting bylaw is deemed to be a defensive measure against takeover or changes in control, it sparks a heightened degree of judicial scrutiny when contested.[219] Supermajority voting requirements inhibit effective monitoring of boards for obvious reasons. In order to pass beneficial proposals, shareholders must convince a much larger swath of the stockholder base than would ordinarily be required. This may even be impossible if incumbent directors, management, and other insiders hold significant minority shares of the company. If a company has an 80% supermajority voting provision for passing bylaw amendments, and management owns 25% of the company's outstanding shares, it would be impossible for anything to pass without management's blessing.

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215. *Id.* at 904–10.

216. Mahoney & Mahoney, *supra* note 209, at 3.

217. *Id.*

218. *See generally* Chesapeake Corp. v. Shore, 771 A.2d 293 (Del. Ch. 2000) (holding that the *Unocal* test must be applied to a board-adopted supermajority bylaw).

219. This standard, referred to as the *Unocal* test, is described more fully in the proceeding section regarding shareholder rights plans and accompanying footnotes. *See infra* note 231 and accompanying text.

3. Shareholder Rights Plans

Shareholder rights plans, or poison pills as they are more colorfully referred to, are devices designed to discourage hostile takeovers by making the target company's stock unattractive to the bidder.[220] Under such plans, a company's board of directors creates and issues rights for existing shareholders to either purchase more of the target company's shares pre-acquisition ("flip-in" plan) or the acquirer's shares post-acquisition ("flip-over" plan) at a discount.[221] These plans activate after a triggering event occurs, such as an announced tender offer or acquisition of a large percentage of the target company's stock.[222] Poison pills also include provisions, which allow the board to cancel ("redeem") the plan.[223] Poison pills make the acquisition of the target extremely expensive by diluting the ownership interests of the acquirer, thereby forcing an acquirer to either negotiate with the board or precluding acquisition altogether.[224] When a poison pill exists, the only other option for an acquirer is to attempt to replace the directors with others who will redeem the pill and allow the takeover.[225]

What makes a poison pill such a powerful tool for management is the ability for the board of directors to unilaterally adopt one without shareholder approval. In the landmark decision by the Supreme Court of Delaware, *Moran v. Household International*,[226] the court held that the *Delaware Code* provided sufficient authority for the board of directors to unilaterally create a shareholder rights plan.[227] Such activity was to be considered within a corporation's "business and affairs," which puts enactment of shareholder rights plans within the board's authority.[228] Furthermore, the court went on to apply a modified business judgment rule[229] to the question of whether the directors violate their fiduciary

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220. Bebchuk et al., *Staggered Boards*, *supra* note 209, at 904–05.

221. Jonathan Shub, *Shareholder Rights Plans—Do they Render Shareholders Defenseless Against Their Own Management?*, 12 DEL. J. CORP. L. 991, 1001–03 (1987).

222. *Id.* at 1003.

223. *Id.* at 1005.

224. *Id.* at 1006.

225. Bebchuk, *supra* note 2, at 684; *see also* MACEY, *supra* note 4, at 123–24. "The harm to acquiring firm shareholders from the triggering of a poison pill is so severe that the poison pill has never been intentionally triggered." MACEY, *supra* note 4, at 124.

226. 500 A.2d 1346 (Del. 1985).

227. *Id.* at 1351–53.

228. *Id.* at 1353.

229. Ordinarily, under the business judgment rule it is presumed that directors of a corporation act "on an informed basis, in good faith[,] and in the honest belief that the action taken was in the best interests of the company." *Id.* at 1356. (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)). It is the plaintiff's burden to overcome the presumption.

duty by using a poison pill.[230] This standard has come to be known as the *Unocal* two-prong test.[231] However, some scholars have noted that judicial scrutiny under this standard has proved "hollow."[232]

B. How Rule 14a-11 Addresses These Issues: Direct Shareholder Intervention and Indirect Disciplinary Effects

Mandatory federally imposed proxy access provides an avenue for shareholders to directly intervene when the board takes actions which shareholders deem contrary to their interests. This is especially important for the entrenchment devices described earlier. For example, if a company has both a classified board and supermajority voting requirements, it may be exceedingly difficult for shareholders to undo these mechanisms by attempting to amend the corporation's bylaws. However, they may be able to more easily replace several board seats with shareholder nominees who can prompt the board to remove the devices.

But, the true benefit of such a rule would likely not come from a shareholder's ability to utilize it in any particular situation. Rather, the most significant benefit would come indirectly from the disciplinary effects of the *threat* of the rule to boards of directors. In other words, boards of directors are more likely to keep the best interests of

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230. *Id*. Under the *Moran* court's modified rule, the burden initially lies with the directors to show "that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed." *Id.* (citing Unocal Corp. v. Mesa Petroleum Co, 493 A.2d 946, 955 (Del. 1985)). This burden is met "by showing good faith and reasonable investigation[.]" *Id.*

231. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). Under the *Unocal* test, the board of directors "must establish: (1) that it had reasonable grounds to believe that the hostile bid for control threatened corporate policy and effectiveness; and (2) that the defensive measures adopted were reasonable in relation to the threat posed." Chesapeake Corp. v. Shore, 771 A.2d 293, 330 (Del. Ch. 2000) (citing *Unocal*, 493 A.2d at 955). The *Unocal* case concerned poison pills. In *Stroud v. Grace*, the Delaware Supreme Court expanded the *Unocal* test to apply "whenever a board takes defensive measures in reaction to a perceived 'threat to corporate policy and effectiveness which touches upon issues of control.'" 606 A.2d 75, 82 (Del. 1992) (quoting Gilbert v. El Paso Co., 575 A.2d 1131, 1144 (Del. 1990)).

232. *See* Theodor Baums & Kenneth E. Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*, 17 (Stanford L. Sch., Working Paper No. 320, 2005); MACEY, *supra* note 4, at 124–26; Lucian A. Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U.L. REV. 489, 516–17 (2002). Professors Bebchuk and Hamdani also note that classified boards were not originally seen as a problem until after the invention of the poison pill. Bebchuk & Hamdani, *supra*, at 516–17. Prior to the poison pill, many institutional investors were willing to vote in favor of classifying a board. *Id.* But, when combined with the effects of a poison pill, institutional investor support for classified boards vanished. *Id.* at 517.

shareholders at heart in order to *prevent* shareholders from ever having to use the rule.

This disciplinary effect, until recently, has largely been theoretical and often debated. But, a recent study conducted by Professor Vyacheslav Fos provides empirical evidence that, when the *likelihood* of a proxy contest increases, boards of directors take actions to attempt to gain shareholder support.[233] Professor Fos's study suggests that "both targeted and non-targeted companies change corporate polices in anticipation of [a] proxy contest. Consistently with the disciplinary effects of proxy contests, future targets and companies that do not end up being targeted change corporate polices in the same direction."[234] More importantly, he found that the disciplinary effects of proxy contests, whether through a materialized contest or an increase in the likelihood of a contest, had positive effects on operating performance.[235]

In other words, the Rule alters the cost-benefit analysis boards of directors engage in when considering whether to adopt entrenchment devices. It becomes more "expensive" for boards to adopt measures and polices that harm value which, without the Rule, would otherwise go unchallenged. The Rule allows the "market" to exert pressure upon boards to adopt only those measures which are truly value maximizing, even when the interests of shareholders and the board do not align.[236] The ramifications of this effect are obvious: While shareholders using the Rule may be able to effect positive change at a single company, the disciplinary effect of the Rule can effect positive changes across all corporations.

C. Establishing a Framework for Analysis

Before any new Rule 14a-11 can be proposed or discussed, a framework must first be established. A proper analytical framework allows for analysis of the predicted efficacy of a new Rule. First, working

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233. Fos, *supra* note 60.

234. *Id.* at 25.

235. *Id.* at 27. Making his findings even more compelling, Professor Fos found that the improvement to operating performance did not come at the expense of significantly increased risk: "To rule out a possibility that the improvement in the operating profitability is accompanied by an increase in riskiness, I considered changes in standard deviation of the operating profit. The unreported results suggest that there is no increase in the operating risk." *Id.* at 27 n.19.

236. This is the logical result of a rebalancing of shareholder and management power. The cost-benefit analysis performed by boards is altered by indirect disciplinary effects, and those boards which ignore the pressure are policed by greater direct intervention by shareholders.

under the assumption that the presence of a classified board, supermajority voting requirements, and shareholder rights plans both reduce firm value and inhibit shareholder oversight, any new Rule should allow shareholders greater voice when companies employ such devices.

In addition, any new Rule should control the costs associated with frivolous proxy contests. Frivolousness, for the purposes of this framework, can be defined as any nomination where the nominating shareholder does not engage in active solicitation or otherwise has a very low probability of winning. For obvious reasons, fighting frivolous contests are a waste of company resources and ultimately, shareholder time and money. Though it may be argued that a company would be unlikely to expend significant resources fighting such a contest, there is a lot at stake. Incumbent directors may feel it necessary, or even part of their fiduciary duty, to mount a strong response to prevent a result which, though unlikely to happen, may result in significant disruption and loss of firm value.[237]

Factors which are likely to affect the number of frivolous contests that occur are: (1) the level of share ownership required to make a nomination; (2) the long-term intentions of the shareholder; and (3) the shareholder's ability to hedge her shares. These three factors determine the economic consequences a shareholder who initiates a frivolous proxy contest will experience. The greater the economic stake required, the less likely that a frivolous contest will be initiated. This must, of course, be balanced against the burden such an economic stake places on proxy contests deemed desirable.

Closely related to concerns over frivolous proxy contests is the issue of "bad" dissident shareholders.[238] A "bad" shareholder, for the purposes of this Note, is a shareholder who initiates proxy contests which would reduce firm value if the shareholder were to be successful.[239] In other words, a "bad" shareholder is one who nominates candidates who are inferior to the incumbent. This issue would arise when the shareholder's nominee is underqualified or inexperienced. It may also result from the shareholder's motivations. A shareholder may be motivated by potential private benefits that may accrue from having her nominee on the board. A shareholder may also be pursuing social policy issues or other special

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237. *See* BUSINESS ROUNDTABLE, BUSINESS ROUNDTABLE COMMENTS, *supra* note 153, at 63–64.

238. The term "bad dissident shareholder" was used by Professor Utpal Bhattacharya in his study analyzing the effects various factors have on the likelihood and success rate of proxy contests. Bhattacharya, *supra* note 76.

239. This definition is also borrowed from Professor Bhattacharya. *See* Bhattacharya, *supra* note 76.

interests which are incompatible with the interests of the majority of other shareholders.

The issue of "bad" shareholder nominations is of particular concern since there is evidence to suggest that, on average, the cost of electing a nominee who is inferior to an incumbent director is greater than the benefit of electing a superior nominee.[240] It is important, however, to bear in mind that this notion applies "on average." In poorly managed companies, the cost of electing a bad nominee is nominal in comparison to the benefit derived from electing a good director.[241] Thus, any new Rule should seek to reduce the number of "bad" shareholder nominations while simultaneously striving to target poorly managed companies. Factors which are likely to affect "bad" shareholder nominations are the same as those for frivolous contests, as well as the minimum standards shareholder nominees must satisfy to use the rule. Once again, the greater the economic stake for the nominating shareholder, the more care she is likely to exercise in choosing board nominees. A large economic stake is also likely to deter social policy activists and those with potential private benefits to gain, since the subsequent cost to the value of their shares likely outweighs the benefits they would accrue.

Finally, any new Rule should control for conflicts of interest among institutional investors. One type of conflict of interest has already been briefly discussed regarding "bad" dissident shareholders who launch a contest in expectation of private benefits other than shareholder wealth. The other is the conflict institutional investors face when voting against management.[242] Many institutional investors have other business interests in the companies they invest in. This may include managing the retirement accounts of the company's employees or providing financial services and credit to the company.[243] As Professor Bebchuk points out:

> Given that a particular money manager's vote is unlikely to be pivotal, and that whatever benefits may arise from an efficient outcome of a vote will largely be captured by others, a money manager's other business interests may have a substantial influence on its vote in such a contest. In particular, the money

240. *Id.* In his study, Bhattacharya found that "it is likely that the assumption that bad dissidents harm more than good dissidents benefit, holds generally in the data." *Id.* at 19.

241. *Id.* "It should be pointed out, however, that for very badly managed firms—where bad dissidents harm less than good dissidents benefit—the . . . results reverse." *Id.*

242. *See* Bebchuk, *supra* note 2, at 704–05.

243. *See* Bebchuk, *supra* note 2, at 705.

> manager might elect to support the incumbent even if the challengers appear to be somewhat better for shareholder value.[244]

In regards to a proxy access rule, the only factor likely to influence this issue is whether proxy voting is confidential or not.[245]

In summary, any new Rule 14a-11 should consider and accomplish the following:

- (1) Discourage "bad" dissident shareholders and frivolous proxy contests by requiring significant long-term share ownership without hedging for risk.
- (2) Protect well managed and well governed companies from such contests because they have more to lose than gain.

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244. Bebchuk, *supra* note 2, at 705.

245. Confidential voting as a default for all proxy contests is favored by Professor Bebchuk and others. There is empirical evidence that suggests that confidential voting may impact voting behavior. One study found that institutional investors who had other business dealings with a company voted in favor of management more often than institutional investors that did not. *See* James A. Brickley et al., *Ownership Structure and Voting on Antitakeover Amendments*, 20 J. FIN. ECON. 267, 276–80 (1988). However, as with most things in the realm of corporate governance, there is also empirical evidence that confidential voting may not actually affect voting behavior. *See* Roberta Romano, *Does Confidential Proxy Voting Matter?*, 32 J. LEGAL STUD. 465 (2003) (finding no evidence that voting behavior changed among institutional investors before and after confidential voting was adopted at the firms studied). This finding does not necessarily conflict with Professor Brickley's results. Professor Brickley found a correlation between voting behavior regarding antitakeover provisions and whether or not the voting institution had conflicting interests. Professor Romano found that institutions with conflicting interests did not change their voting behavior on shareholder proposals, including antitakeover provisions, after a company adopted confidential voting. This does not necessarily mean that institutions with conflicting interests and those without do not have different views on corporate governance, nor does it necessarily mean that confidential voting has no impact on voting behavior. Even in the presence of confidential voting, there is still risk that an institutional investor's voting record will be disclosed to the public. For example, Institutional Shareholder Services Inc. (ISS) recently settled an SEC action against the company for leaking confidential information on proxy votes for more than one hundred of ISS's clients in exchange for concert and sporting event tickets. Erik Holm, *ISS Employee Leaked Proxy Votes for Concert Tickets, SEC Says*, WALL ST. J. (May 23, 2013), http://online.wsj.com/article/BT-CO-20130523-710650.html. Eugene Goldman, former senior counsel in the SEC's division of enforcement, was quoted saying, "The case suggests there is a real interest in this information . . . . That's why the proxy solicitor furnished an airline ticket, show tickets, meals, tickets to sporting events." Emily Chasan, *Proxy Voting Confidentiality Gets a Closer Look*, WALL ST. J. (May 28, 2013), http://blogs.wsj.com/cfo/2013/05/28/proxy-voting-confidentiality-gets-a-closer-look/. It may be that the risk of disclosure simply outweighs the potential benefits of voting against management for institutional investors with conflicting interests. The calculus may indeed be different when the potential gains outweigh these risks, which is quite possible in the context of a proxy contest.

- (3) Balance the above two concerns with the need to make the rule accessible and practicable for shareholders who wish to initiate desirable proxy contests.
- (4) Increase shareholder access to companies which employ entrenchment devices such as a classified board, supermajority voting, and shareholder rights plans.
- (5) Account for the potential conflicts of interest institutional investors may face when voting their proxies.

V. A NEW RULE 14A-11

Using the principals outlined above, I propose the following changes to Rule 14a-11. Each proposed change will be justified and analyzed using the framework previously described in order to show how it is a more favorable alternative to the SEC's original Rule.

A. Incorporate the Ability to Opt-Out

In designing a new Rule 14a-11, a mechanism by which companies can "opt-out" should be included as a fail-safe against unforeseen effects and to avoid eliminating private ordering in the realm of proxy access entirely. To prevent the undermining of the Rule, a company should only be able to opt-out through an 80% supermajority of shareholder votes cast. As a further protection to shareholders, a company which does opt-out should be required to "renew" the opt-out every five to ten years.[246] This prevents the "opt-out" from becoming irreversible even when the will of shareholders changes.

A crucial shortcoming of the Rule as proposed by the SEC was its lack of flexibility in accommodating private ordering by summarily rejecting the idea of allowing companies to opt-out.[247] The SEC argued that any mechanism for opting out of the Rule, even one by majority shareholder vote, would "diminish the rights of shareholders who participate by proxy[,]" especially the rights of minority shareholders.[248] It also argued that shareholders currently "do not have the option to elect

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246. The idea of having a "sunsetting" opt-out was proposed in a letter from ten Harvard Business and Law professors who approved of the Rule, but expressed concern over its "one-size-fits-all" approach. Letter from Jay W. Lorsch et al., Professor, Harvard Business School, to Elizabeth M. Murphy, Sec'y, Sec. and Exch. Comm'n 3 (Aug. 13, 2009) [hereinafter Letter from Ten Harvard Professors], *available at* http://www.sec.gov/comments/s7-10-09/s71009-164.pdf.

247. Adopting Release, s*upra* note 17, at 56,680.

248. *Id.*

to opt-out of other federal proxy rules[,]" and that allowing companies to adopt differing procedures could "add significant complexity and cost[.]"[249]

Although the SEC's arguments against an "opt-out" mechanism have merit, concerns over this "one-size-fits-all" approach are persuasive.[250] By preventing a company from formulating its own governance practices, innovation and responsiveness to new developments can be severely hampered. This includes new innovations in corporate governance. One of the most persuasive arguments in favor of allowing opting out of the Rule came from a comment by Shearman and Sterling LLP:

> If shareholders do not have the ability to the opt-out of Rule 14a-11, the unfortunate result of the Commission's proxy access initiatives would be a stifling of the natural process of private ordering that would otherwise occur. We believe that private ordering has proven to be a very effective mechanism for corporate governance change in recent years—illustrated, for example, by recent movements toward majority voting, board declassification and redemptions, terminations[,] and non-renewals of shareholder rights plans (or "poison pills").[251]

In other words, companies and shareholders would be unable to adopt measures similar to Rule 14a-11, but with minor—but possibly significant—differences that may benefit a particular company's governance. For example, a hypothetical corporation may have an unusually high number of shareholders who own significant blocks of voting power. Such a company, along with a majority of its shareholders, may wish to increase the level of ownership required to include a nominee on the company's proxy. It may also wish to allow for more lenient word limits and more stringent disclosure requirements for nominating shareholders to improve the flow of information beneficial to all stockholders. Such an arrangement would be invalidated by Rule 14a-11, as proposed by the SEC or a version which includes the revisions proposed in this paper.

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249. *Id.*

250. Forty-four comments submitted to the SEC regarding the Rule expressed desire to have some ability to opt-out. *Id.* at 56,679 n.84. While the majority of these comments came from corporations who would be subject to the rule and their counsel, one came from a group of ten Harvard Business School and Harvard Law School Professors. *See* Letter from Ten Harvard Professors, *supra* note 246, at 3.

251. Letter from Shearman & Sterling LLP to Elizabeth M. Murphy, Sec'y, Sec. and Exch. Comm'n (Aug. 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-293.pdf.

The ability to "opt-out" is supported even by those who advocate greater proxy access in general.[252] As Professor Bebchuk—who supported the Rule—has written in the past: "One size does not fit all, and companies should be able to opt into different arrangements."[253] He also argued that any rules put forth by public officials regarding proxy access should serve as a "default" arrangement, and although opt-out should be possible by shareholder vote, board-adopted bylaws which constrain access should be curtailed.[254] This is a persuasive proposition, considering the purpose of broader proxy access is to help alleviate the current imbalance between the power of entrenched directors and the power of shareholders who wish to oust them.

Requiring that an opt-out from the Rule be done through a supermajority shareholder vote, coupled with affixing a sun-setting provision to the opt-out, helps correct this imbalance while retaining a company's ability to engage in private ordering. Additionally, it serves as a safety precaution. While theory and data strongly suggest that a rule which facilitates proxy access will improve company performance, there is no way of proving definitively that it will work for every corporation because nothing like this has been done before in the United States.[255] In order to account for any uncertainty that exists, an opt-out mechanism is desirable to allow corporations and their shareholders to eliminate the costs of the rule should it not benefit them.[256]

Thus, the opt-out mechanism proposed satisfies two elements of the framework. It protects well-managed and well-governed companies by providing at least some degree of flexibility if the Rule proves to be unduly burdensome at that particular firm. It also balances the competing interests of protection and shareholder access by requiring significant shareholder support to opt-out. Additionally, it can defray some of the potential unintended costs the Rule may impose.

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252. *See* Bebchuk, *supra* note 2, at 707–11. Professor Bebchuk was also the signatory of a comment letter to the SEC regarding Rule 14a-11 subscribed to by eighty other professors of law, business, economics, and finance which supported the rule as proposed. *See* Letter from Lucian A. Bebchuk et al., Professor, Harvard Law School, to Elizabeth M. Murphy, Sec'y, Sec. and Exch. Comm'n (Aug. 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-293.pdf. Notably though, the comment letter did not mention or comment on an "opt-out" mechanism. *Id.*

253. Bebchuk, *supra* note 2, at 707.

254. *Id.* at 709–11.

255. As Professors Hayden and Bodie point out, any existing or proposed empirical research studies are necessarily "examining something that, while similar, is not identical to what the SEC is proposing in this rule." Any study that examines proxy challenges "is not directly comparable to Rule 14a-11" and therefore cannot be definitive. Hayden & Bodie, *supra* note 102, at 123–24.

256. *See* Letter from Ten Harvard Professors, *supra* note 246, at 3.

B. Reduce the Ownership Threshold to Two Percent and Establish "Triggering" Conditions Which Reduce the Threshold Further to Half a Percent

It is necessary to balance the need for shareholder access with the potential disruptions companies may face. But, as critics have pointed out, the Rule as originally adopted imposed too severe a holding requirement to allow it to be effectively used.[257] Therefore, a new Rule 14a-11 should have a lower ownership threshold requirement, such as 2%[258] of a company's voting power. Furthermore, in order to make the Rule a more powerful and accessible tool for shareholders when companies exhibit governance problems, this Note proposes using the concept of "triggering"[259] conditions to decrease the ownership threshold requirement to 0.5%. These triggering conditions would be:

- (1) One or more director nominees receive withhold votes of 25% of all votes cast at a shareholder meeting in the past three years;
- (2) A shareholder proposal to amend bylaws concerning board nomination or election processes receives at least 40% approval in the past three years; and
- (3) The presence or adoption of a shareholder rights plan, classified board, or supermajority voting requirement.

If any of these three conditions exist, the threshold would be reduced to 0.5% to give shareholders greater access to that company's proxy ballot.

The SEC had originally proposed a tiered ownership threshold requirement, whereby a nominating shareholder would need to hold either 1%, 3%, or 5% of the voting power of the company's securities entitled to be voted, depending on a company's status as a large accelerated filer, an accelerated filer, or a non-accelerated filer.[260] This

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257. *See supra* Part III.B.

258. The majority of commenters to the Rule had suggested using a 5% threshold or similar. *See* Adopting Release, *supra* note 17, at 56,689 n.204–208. These commenters were, by and large, corporate commenters and their counsel.

259. *Id.* at 56,680. In its 2003 proposal for Rule 14a-11, the SEC proposed that one of two "triggering events" occur before the Rule would be available to a nominating shareholder. The two triggering events were: (1) The company's nominees "received withhold votes of more than 35% of votes cast" at the prior year's annual shareholder meeting; or (2) that a shareholder proposal submitted under Rule 14a-8 proposing a shareholder nomination procedure received more than 50% of votes cast. *Id.* These triggering events were designed to prevent Rule 14a-11 from being used unless a company exhibited potential governance problems. *Id.* at 56,681.

260. *Id.*, at 56,689. The original proposed rule required that a shareholder hold at least 1% of the voting power for "large accelerated filers," 3% for "accelerated filers," and 5% for "non-accelerated filers." *Id.* A "large accelerated filer" is a company with "an aggregate

was done in recognition that some companies, based on their size, may have been disproportionately affected by a uniform standard. This scheme was abandoned in favor of a uniform 3% ownership threshold in response to commenters who were concerned with the workability and possibility for abuse of a tiered structure.[261] The SEC also expressly rejected the idea of including triggering events or conditions in Rule 14a-11, believing it would unduly impede shareholder use of the Rule and would add unnecessary complexity.[262] However, neither the SEC nor any commenters appear to have considered using "triggering" events or conditions to *reduce* the requirements of the Rule for companies that exhibit potential governance issues. Rather, the Commission only considered using these events as a necessary condition for using the Rule at all.[263]

Based in part on the SEC's data provided in support of the Rule, decreasing the holding threshold to 2% absent any triggering conditions appears prudent. According to the SEC's data,[264] 89% of all large accelerated filers and 92% of accelerated filers had two or more

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worldwide market value of the voting and non-voting common equity held by its non-affiliates of $700 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter." 17 C.F.R. 240.12b-2(2)(i). An "accelerated filer" is a company with an aggregate value of more than $75 million but less than $700 million. 17 C.F.R. 240.12b-2(1)(i). A non-accelerated filer is a company with a value less than $75 million.

261. Adopting Release, *supra* note 17, at 56,690. One commenter noted: "[I]t is inevitable that among the thousands of issuers that are subject to the Proxy Rules, a number of such companies regularly move from one category to another as the aggregate worldwide market value of their voting and non-voting common equity changes from fiscal year to fiscal year." Shearman & Sterling LLP, *supra* note 251. Such movement would cause uncertainty and pose significant problems to the Rule's workability. The SEC also noted that a uniform standard would "avoid any ability on the part of management to structure corporate actions to modify the impact of Rule 14a-11 by placing the company in a different tier." Adopting Release, *supra* note 17, at 56,690.

262. *Id.* at 56,681. The complexity argument is puzzling. Under the current system, shareholders must contend with a plethora of varying state laws, corporate charters, and bylaws. Just how simplifying the system to a single Rule, even with tiered ownership thresholds and triggering events, is unduly complex is unclear.

263. *Id.* at 56,680–81.

264. The SEC's data included shareholder holdings information from a set of 5,327 companies between January 2008 and April 2009, as well as a second set of shareholder holdings information based on all third-quarter 2008 Form 13-F filings. *See* Facilitating Shareholder Director Nominations, 17 C.F.R. pts. 200, 232, 240, 249, 274 (proposed) [hereinafter Proposed Rule]. This data is being used as opposed to the figures published in the final rule because the latter was adjusted to reflect only those shareholders who have held on to their shares for at least three years. *See* Adopting Release, *supra* note 17, at 56,690 n.221. Because this Note is proposing to eliminate the requirement of holding the necessary percentage of voting power for any length of time, the data provided in the SEC's original proposal is more appropriate.

shareholders who held at least 1.5% of a company's voting power.[265] In another data set of fifty large accelerated filers, provided by Professor Jonathan Macey and Elaine Buckberg of NERA Economic Consulting,[266] 94% of sampled companies had between five and nineteen shareholders who held at least 1% of the company's voting power.[267] This means that the vast majority of companies would have had at least two shareholders with the ability to aggregate their holdings to meet the 2% threshold. The data also suggests that a 2% threshold would provide a sufficient barrier to proxy access to discourage frivolous contests.

The argument that setting the ownership threshold too high will make the Rule unusable when it matters most is also compelling and should be addressed. This is why incorporating triggering conditions to reduce the ownership threshold to increase proxy access for companies that exhibit governance issues or significant shareholder dissatisfaction should be incorporated. If the threshold is reduced to 0.5% once a triggering condition occurs, almost all companies would have at least one—and likely more—shareholder who could utilize the Rule to effect change.[268] Moreover, the three triggering conditions proposed are strong indicators of either corporate governance problems or impaired firm value.[269] It also makes intuitive sense: If a board fails to acquiesce to the will of its shareholders (triggers one and two) or erects barriers to shareholder oversight (trigger three), then the board should be exposed to greater competitive pressure and ouster if it also fails to articulate a convincing argument for why its actions are in the best interest of shareholder value.

The proposed tiered ownership threshold activated by triggering conditions satisfies four elements of the framework. It discourages "bad" dissident shareholders and frivolous contests by requiring a significant stake of 2% when a company does not exhibit governance issues.[270] The

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265. Proposed Rule, *supra* note 264, at 46–48.

266. This data was provided in support of comments by Business Roundtable.

267. *See* BUCKBERG & MACEY, *supra* note 132, at 14 fig.2.

268. Based on the SEC's data, 99% of large accelerated filers have at least two shareholders who own 0.5% of the company's voting power, and over 92% of accelerated filers have at least one shareholder with 1% or more voting power. *See* Proposed Rule, *supra* note 264, at 45–46. According to Professor Macey's data, 96% of sampled large accelerated filers have two or more shareholders with 1%, and 94% have five or more shareholders with 1% each. *See* BUCKBERG & MACEY, *supra* note 132, at 14 fig.2.

269. *See supra* note 209 and accompanying text.

270. One may wonder why companies which do not present indicators of governance problems should be subject to the Rule at all. Not all problems are the result of the issues addressed by the triggering conditions. For example, a company may have all the right processes and procedures in place, but the directors fail to properly utilize them. Sometimes directors are just bad managers who make bad decisions. Shareholders should, in those

triggering conditions protect well-managed and well-governed companies, while balancing the need for protection with access. The triggering conditions also increase access to companies who employ value-reducing entrenchment devices. Special attention, though, must be paid to constructing the Rule in a way which excludes shareholders who have hedged their positions. Hedging destroys the incentives and protections provided by the ownership threshold.[271]

C. Eliminate the Three-Year "Holding Period"

A new Rule 14a-11 proposal should not require a nominating shareholder to have held its qualifying percentage of voting shares for any length of time. The SEC originally included a one-year holding period requirement because it believed it to be an indicator of a shareholder's long-term interest in the company.[272] Most comments received by the SEC supported this aspect of the Rule, but advocated a longer holding period.[273] In response, the SEC elected to adopt a three-year holding requirement in its final rule.[274] The Commission also justified extending the holding period as an additional safeguard against shareholders with a change-in-control intent from utilizing the Rule.[275]

However, the best indicator of long-term interest is the actual intent of the shareholder post-election. In determining whether a shareholder is concerned only with short-term changes as opposed to long-term value, it matters not how long the shareholder has held her shares before taking action. However, what does matter is how long she intends to hold her shares should her nominees be elected to the board.[276] The SEC recognized this when it proposed requiring nominating shareholders to disclose their intent regarding continued ownership of shares after the

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instances, continue to have access to the company's ballot. The 2% barrier makes sense in these cases. Presumably, if a company has "good bones" but lousy management, it would be a prime target for activist investors who can justify the significant stake in shares.

271. The SEC contemplated this problem and addressed it through its formula for determining whether the share ownership threshold has been met. *See supra* text accompanying notes 113–14. The effectiveness of the SEC's construction of the Rule regarding hedging is well beyond the scope of this Note, but it is important enough to mention in discussing these revisions.

272. Adopting Release, *supra* note 17, at 56,697.

273. *Id.*

274. *Id.* at 56,697–98.

275. *Id.* at 56, 698.

276. Professor Bebchuk has made this same conclusion, noting that it is unclear whether a minimum holding requirement is desirable. Bebchuk, *supra* note 2, at 697. "[W]hat matters is not how long a shareholder has already held shares in the company, but rather how long the shareholder plans to hold the shares going forward." *Id.*

election through an amended Schedule 14N.[277] Nominating shareholders would then be liable for false and misleading statements through an amended Rule 14a-9,[278] creating the necessary safeguard against short-termism without the need for a holding requirement.

Besides being an inferior indicator of long-term intent, a holding requirement would likely discourage many of the investors most willing to use Rule 14a-11 to profit from future gains in a company's performance.[279] Activist investors seek out underperforming companies where a management shake-up may yield shareholder gains. A holding requirement discourages these investors from using the Rule to run "short-slate" contests by decreasing their potential profits and increasing the risk of their investment. It is logical that an activist investor would rather invest in a potential target it could influence immediately rather than tie up its capital for one to three years in a company whose short-term prospects are uncertain.[280]

Additionally, there are other ways of providing greater safeguards against short-termism which would not discourage the type of nominating shareholders beneficial to a company's long-term improvement. For example, nominating shareholders using the rule could be subject to an economic penalty for selling shares too quickly after an election.[281] Substantially reducing or eliminating a shareholder's ability

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277. Adopting Release, *supra* note 17, at 56,699.

278. *Id.* at 56,738–39. The specific language of the amendment to Rule 14a-9 would have expressly mentioned false or misleading statements which a nominating shareholder caused to be included in a registrant's proxy materials, including in a notice on Schedule 14N. 17 C.F.R. § 240.14a-9(c) (proposed).

279. *See* Professor Fisch's comments, *supra* Part III.B and accompanying notes.

280. A holding period is also problematic for other institutional investors, such as hedge funds. Hedge funds, due to their scrupulous attention to internal rates of return, are unlikely to invest significant capital for several years while suffering minimal or even negative returns. *See* Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347, 1376 (2011) (discussing why proxy access, as proposed by the SEC, would have likely been ineffectual).

> If a hedge fund buys a $100 million stake and, within one year, changes things enough to increase the share price by 20%, it has a gross annual return of 20%. If, to take advantage of the costs savings of proxy access, the hedge fund holds the position for three years, earns a "normal" return of 5% in the first three years and then gets the same outcome with a 20% return in the fourth, the gross annual return goes from 20% per year to 8.6% per year.

Id.

281. Faculty members of Harvard Business and Harvard Law School proposed the idea of an economic penalty, similar to the short-swing profit rules in § 16 of the Securities Exchange Act of 1934. Letter from Ten Harvard Professors, *supra* note 246, at 2.

to realize short-term gains from a proxy contest would go a great deal further in preventing short-termism than any holding requirement.

Eliminating the holding period requirement and potentially adopting other provisions to combat short-termism satisfies two of the framework's criteria. It works in tandem with the threshold requirements by discouraging "bad" dissident shareholders and encourages "good" dissident shareholders by making the Rule more attractive to sophisticated investors with sufficient capital to properly conduct proxy solicitation. It also balances the need for protection and access by eliminating one of the biggest barriers to the original Rule's practicability.

D. Make Compliance with a Company's More Stringent Director Independence Standards a Requirement for Shareholder Nominee Eligibility

In addition to requiring that a shareholder nominee meet the objective criteria[282] for independence of the national securities exchange rules applicable to the company, the nominee should also be required to meet the objective independence standards set forth by the company's governing documents. Under the Rule as proposed by the SEC, a nominating shareholder would only need to disclose whether, to the best of its knowledge, the nominee meets the company's director qualifications standards.[283] The Commission's sole justification was that, under state law, "shareholders generally are free to nominate and elect any person to the board of directors, regardless of whether the candidate satisfies a company's qualification requirement at the time of nomination and election."[284] While it is admirable to attempt to respect state law regarding director nominations, the need to do so is unclear and undermines one of the most important justifications for the Rule: improving corporate governance.

The Rule was designed to coexist with existing state and federal law regulating director elections by offering an *alternative* to a traditional proxy contest.[285] As an alternative to the status quo, it is justifiable to

282. *See supra* note 120 and accompanying text.

283. Adopting Release, *supra* note 17, at 56,703–05.

284. *Id.* at 56,704 (citing Triplex Shoe Co. v. Rice & Hutchins, Inc., 152 A. 342, 375 (Del. 1930) and 1–13 DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE § 13.01 n.42 (2009)).

285. *Id.* at 56,680–81. "It is important to note that while Rule 14a-11 facilitates the existing rights of shareholders . . . [,] it is not the exclusive way by which a candidate may be put to a shareholder vote." *Id.* at 56, 680.

impose requirements above and beyond what shareholders would currently face using the traditional proxy process. To be sure, the Rule would not serve as an alternative *without* differing requirements and standards. Furthermore, the primary justification for the Rule as a whole is to facilitate a shareholder's right to control, monitor, and discipline a company's board through the board nomination process in an effort to *improve* corporate governance and performance. To allow a nominating shareholder to abrogate a company's attempt to improve its governance by strengthening its director independence standards is illogical and counterproductive.

This proposed revision to the Rule satisfies one of the framework's criteria. It helps protect well-governed companies by preventing shareholders from disrupting a company's attempt to strengthen its governance standards.

E. Make Confidential Voting the Default

In order to further facilitate and give increased proxy access its full intended effect, a new Rule should strike SEC Rule 30b1-4 and make confidential voting the default for all companies within the SEC's purview. Rule 30b1-4 requires that all management investment companies publicly disclose its proxy voting record.[286] Surprisingly, the issue of confidential voting was not raised by the SEC or any of the comment letters responding to the proposed Rule.

Many institutional investors have business arrangements with the companies they invest in, such as managing employee retirement accounts or providing financial services to the company.[287] Therefore, these institutional investors have a powerful interest in remaining loyal to management despite recognizing that a change in the board would benefit shareholder value.[288] These conflicting interests, combined with the effects of Rule 30b1-4 and the fact that most companies do not have

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286. 17 C.F.R. § 270.30b1-4 (2013); Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188, Exchange Act Release No. 47, 304, 68 Fed. Reg. 6564 (Feb. 7, 2003).

287. *See* Bebchuk, *supra* note 2, at 704.

288. Although this proposition is accepted by many scholars, there is at least one study which found evidence to the contrary. In her study titled *Does Confidential Proxy Voting Matter?*, Professor Roberta Romano found no evidence that confidential voting affected the voting behavior of institutional investors with conflicting interests. Romano, *supra* note 245, at 506. However, the study only looked at voting behavior regarding shareholder proposals, not proxy contests. It therefore has limited applicability in this context.

confidential voting,[289] create a serious impediment to the success of a nominating shareholder's use of the Rule. While confidentiality would not protect the nominating shareholder for obvious reasons, it may significantly impact the nominating shareholder's ability to garner sufficient support to win a contested election and therefore her choice to use the Rule at all. Empirical evidence also supports the conclusion that institutional investors are influenced by such conflicts of interest.[290]

In the very least, setting confidentiality as the default would likely have no adverse impact on companies.[291] The costs of a confidential voting system is neither expensive nor difficult to administer.[292] Proposals for confidential voting also enjoy widespread shareholder support.[293] Therefore, confidentiality will either provide meaningful force to a new Rule 14a-11, or, at worst, appease shareholders at minimal cost. This proposed revision would satisfy one of the framework's criteria. Confidential voting accounts for the potential conflicts of interest institutional investors may face when voting their proxies.[294]

F. Amend Rule 14a-8(i)(12)

Any new Rule 14a-11 should further amend Rule 14a-8 to allow for more frequent resubmission of shareholder proposals relating to the nomination and election of directors. Rule 14a-8, as it stands, limits the resubmission of an unsuccessful attempt to amend bylaws governing director nomination and election to once every five years if it received less than 3% of votes cast, twice if it received less than 6%, and three times if it received less than 10%.[295] In order to better facilitate the use of a new Rule, this 14a-8 should be amended to allow resubmission of such

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289. *See* Bebchuk, *supra* note 2, at 704 n.49.

290. *Id.* at 704.

291. Professor Romano found that most firms in her sample adopted confidential voting without a shareholder vote, and of the firms that did put the issue to vote, all firms where the proposal received majority support were adopted. Romano, *supra* note 245, at 474–75. This indicates that firms are willing to adopt confidential voting, or at least see no significant disadvantage in adopting it.

292. SUBODH MISHRA, RISKMETRICS GROUP, 2008 BACKGROUND REPORT: CONFIDENTIAL AND CUMULATIVE VOTING 8 (2008).

293. *Id.* at 4 tb.l.1.

294. It may also partially address the potential concern raised *supra* note 245 and accompanying text, regarding unwanted disclosure of institutional investor proxy voting information. Although it does not address unwanted disclosure through bribery, *see supra* note 245, it does help to prevent companies from inferring how an investor voted in an election from its voting behavior in other contests.

295. 17 C.F.R. 240.14a-8(i)(12).

proposals every three years if they receive less than 3% of votes cast, with no restriction if they receive more than 3%.[296]

Rule 14a-8 obligates companies to include certain shareholder proposals on its proxy statement.[297] Subsection (i)(12) limits the frequency with which shareholder proposals that are unsuccessful may be resubmitted under the rule.[298] A shareholder must have continuously held at least $2,000 or 1% of a company's securities entitled to be voted for at least one year by the date the shareholder submits its proposal.[299] A company may exclude proposals from its proxy materials if they fail certain requirements or fall within certain categories.[300]

In the past, Rule 14a-8 was interpreted by the judiciary to allow a company to exclude from its proxy materials any shareholder proposal which dealt with director elections.[301] In 2006, the Second Circuit reversed this interpretation.[302] In response, the SEC amended the rule in 2007 to explicitly exclude proposals that relate to procedures for nomination or election of directors.[303] In 2010, the SEC again amended the rule. This time it removed the exclusion, allowing such proposals to proceed under the rule.[304] Many of the comments to Rule 14a-11 suggested that this amendment alone was sufficient to adequately

296. This proposed amendment would *only* apply to proposals which seek to amend bylaws in regards to director nominations and elections.

297. *See* 17 C.F.R. 240.14a8.

298. Shareholder proposals which are substantially the same as prior proposals included in the company's proxy materials within the preceding five years may be excluded if they received only a small number of votes in favor. *See* 17 C.F.R.240.14a-8(i)(12).

299. *See* 17 C.F.R. 240.14a-8(b).

300. *See* 17 C.F.R. 240.14a-8(i). A company may exclude from its proxy materials any proposal which, among other reasons: (1) violates law; (2) violates proxy rules; (3) relates to a personal grievance or special personal interest; (4) relates to operations which account for less than 5% of the company's total assets; (5) the company lacks the power or authority to implement the proposal; (6) the proposal deals with the company's ordinary business operations; (7) the proposal nominates, disqualifies, removes, or questions a director or director nominee; (8) the proposal affects an outcome of an upcoming election of directors; (9) the proposal directly conflicts with a company proposal to be submitted at the same shareholder meeting; or (10) the company has already substantially implemented the proposal or the proposal is duplicative. *Id*.

301. 1 CORPORATE GOVERNANCE: LAW & PRACTICE ch. 3, § 3.05(4)(b)(iii) (Amy L. Goodman and Steven M. Haas eds., Matthew Bender & Co. 2013) [hereinafter CORPORATE GOVERNANCE].

302. *Id.*; *see also* Am. Fed'n of State, Cnty. & Mun. Emp v. Am. Int'l Group, Inc., 462 F.3d 121 (2d Cir. 2006).

303. CORPORATE GOVERNANCE, *supra* note 301.

304. *Id.* This amendment was part of Rule 14a-11. *See* Adopting Release, *supra* note 17, at 56,730. The amendment was not reversed with the rest of the rule and continues to persist.

improve shareholder proxy access and advocated abandoning the rest of the Rule.[305]

The amendment alone, while being a positive first step, is insufficient in bringing about the sort of board accountability the SEC and others envisioned. First, it is logical to assume that any company with an entrenched board of directors would fight vigorously against any shareholder proposal that would make it easier to oust them.[306] Therefore, a shareholder who seeks to effect positive change in the board through Rule 14a-8 would need to fight two battles: one to enact favorable nomination and election procedures, and a second to actually have its nominee elected. In essence, the shareholder is no better off than she would have been without the rule, and resorting to a traditional proxy contest would be the more logical approach.

Second, it is unclear how effective shareholder proposals to amend a company's bylaws would be. Rule 14a-8 does not allow proposals which violate state law[307] and not all states allow binding shareholder proposals. In these states, such proposals would merely be advisory in nature; the company would not be obligated to adopt the measure even with overwhelming shareholder support. Also, some states—including Delaware—allow boards of directors to unilaterally amend or repeal bylaws.[308] Therefore, even if a binding shareholder proposal is lawful and succeeds, the company may be able to unilaterally repeal it.

Considering these two points, the argument that Rule 14a-8 as it exists today is sufficient without a new Rule 14a-11 is unpersuasive. It is only through the interaction between the two rules that meaningful change is possible. With both in place, a shareholder could submit a proposal to amend bylaws under Rule 14a-8, while using leverage gained by the threat of a 14a-11 nomination to prompt a board to take positive action. Where the proposal is binding, it may induce the board to put up less of a fight. Where the proposal is nonbinding, it may make the board more responsive if the proposal receives majority support. The interaction between the rules would also benefit the shareholder who intends to nominate directors through Rule 14a-11. By putting forth a shareholder proposal which receives at least 40% approval from shareholders, it can force a triggering condition, making the nomination of new directors easier. This proposed revision satisfies three of the framework's criteria.

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305. *See supra* note 173.

306. This was the basis for concern over the cost of the Rule. However, the Business Roundtable, and Buckberg and Macey couched the issue as a matter of fiduciary duty rather than entrenchment. *See* BUCKBERG & MACEY, *supra* note 132, at 8.

307. 17 C.F.R. 240.14a-8(i)(2).

308. *See, e.g.*, DEL. CODE ANN. tit. 8, § 109(a) (2013).

It balances the need for protection and access by protecting companies who are responsive to shareholders while increasing access to those that are not.

VI. COST-BENEFIT ANALYSIS AND SURVIVING JUDICIAL SCRUTINY

Whether or not a revised Rule 14a-11 would survive the intense standard of scrutiny the D.C. Circuit has imposed upon the SEC[309] is beyond the scope of this Note. However, some attention to how these proposed revisions could positively affect the SEC's cost-benefit analysis is worth discussing. It is important to recall that the available empirical data regarding the economic effects of increased shareholder involvement supports three important conclusions. First, proxy contests involving short-slate nominations which result in "hybrid" boards have a positive impact on firm value in the aggregate.[310] Second, increased shareholder involvement has a disciplinary effect on all companies, regardless of whether any specific company is being targeted by a potential proxy contest.[311] As the threat of a proxy contest increases, boards attempt to make changes in order to appease shareholders to prevent the contest from materializing. Finally, third, proxy contests are likely to significantly benefit poorly performing firms while potentially harming well-managed firms.[312] It should also be reiterated that the purpose of the revised Rule 14a-11 is to improve corporate governance and firm performance, rather than "facilitate the effective exercise of shareholders' traditional state law rights to nominate and elect directors" merely for the sake of increasing the number of proxy contests. It is against this backdrop that the revisions proposed in this Note would not only improve governance, but also facilitate the SEC in formulating a more convincing cost-benefit analysis.

With the addition of a tiered ownership threshold activated by triggering conditions, the revised Rule would target companies which exhibit governance or performance problems.[313] This would allow the SEC to better utilize existing empirical data to estimate the Rule's impact by focusing on the improvement poorly managed companies experience from proxy contests. It would also allow the SEC to provide an estimate of the potential increase in the number of proxy contests the

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309. *See supra* notes 92–94 and accompanying text.
310. *Supra* note 147 and accompanying text.
311. *Supra* Part IV.B.
312. *Supra* notes 240–241 and accompanying text.
313. *Supra* Part V.B.

Rule would produce.[314] Rather than attempting the impossible task of estimating the probable increase in proxy contests across *all* companies, the SEC would be able to focus on the smaller dataset of firms which utilize entrenchment devices, have been targeted by shareholder proposals, or employ directors who receive significant withhold votes.[315]

The SEC could also be more aggressive in its advocacy for the Rule. Rather than shroud its interpretation of available data in ambiguity to avoid criticism that a 3% ownership threshold makes the Rule ineffective, it could embrace it. The tiered ownership threshold protects well-run companies from potentially value-reducing contests, while exposing companies with demonstrated issues to potential value-maximizing contests. In other words, the SEC could use concerns over the Rule as originally adopted to its advantage. Without these revisions, the SEC is stuck performing the difficult dance of showing how the Rule increases the number of proxy contests as to provide a net-benefit on the one hand, but does not increase the costs of frivolous contests on the other.

Finally, the presence of a "fail-safe" opt-out mechanism would drastically reduce any potential unforeseen costs and effects. Because companies and their shareholders are more likely to react faster than regulators, the presence of a fail-safe mitigates the potential—though unlikely—scenario where it all goes wrong. It also opens the door for a more efficient proxy rule through private ordering if a strong enough case can be made to overcome the 80% supermajority-voting requirement.

In sum, the revisions proposed in this Note would allow the SEC to provide more concrete evidence and support for its position by reducing its effects on all companies in the aggregate while increasing its effects on a targeted few.

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314. The D.C. Circuit found the absence of this data particularly troubling. *See* Business Roundtable v. SEC, 647 F.3d 1144, 1153 (D.C. Cir. 2011).

> In weighing the rule's costs and benefits, however, the Commission arbitrarily ignored the effect of the final rule upon the total number of election contests. That is, the Adopting Release does not address whether and to what extent Rule 14a-11 will take the place of traditional proxy contests. Without this crucial datum, the Commission has no way of knowing whether the rule will facilitate enough election contests to be of net benefit.

Id.

315. These companies are already more likely targets of traditional proxy contests, albeit an insufficient number of them. It stands to reason that predicting whether these firms would experience an increase in contests would be far more practical than attempting to produce estimates for all publicly-traded firms as a whole. It may even be possible to provide institutional investors with the specific dataset of companies that would be subject to the 1% threshold and ask if the Rule would affect their decision to invest and wage a proxy battle.

VII. CONCLUSION

The agency problem is a very real issue of great importance. The Disney case with which this Note opened is not only an interesting example of managerial abuse, but illustrative of the deficiencies inherent in the current proxy system. Although Disney's shareholders were well aware of the shortcomings of the company's board, the vast majority of them were powerless to effect change. For almost a decade, Disney's shareholders were forced to vote for the same incumbent directors with no alternatives to choose from. Those same incumbents were also shielded from judicial intervention by the business judgment rule. This protection was warranted. The Disney directors, including the Chairman and CEO, did not violate the law. They were simply bad managers. Bad managers can only be effectively dealt with by private actors who monitor management and discipline them when necessary.

Shareholders are private actors in an ideal position to act as these monitors, as they are personally invested in the future of the companies they own. Shareholders' primary tool for monitoring and disciplining boards of directors is the market for corporate control. However, serious impediments exist within the current system which greatly reduce the shareholders' ability to utilize the market for control. These impediments are both economic and artifacts of law.

Fortunately, proxy contests show great promise for revitalizing the market for corporate control due to recent calls for reform after the 2008 financial crisis and the passage of Dodd-Frank. For the first time, corporate governance has been squarely placed within the ambit of federal regulation. Using this grant of authority and building upon a foundation of favorable state common law, the SEC implemented Rule 14a-11, opening the corporate proxy ballot to shareholders most likely to act in the best interests of all shareholders. The promise of effective shareholder monitoring of corporate management performance and the disciplinary effects that come with it seemed to have finally arrived. But the Rule was not without its flaws, and was ultimately invalidated by the D.C. Circuit. However, the will still exists within the SEC to try again.

Much has been learned since the Rule was vacated. The Rule as enacted deserved much of the criticism it received. That criticism will hopefully lead the SEC to draw upon the lessons learned should it attempt a proxy access rule again, and construct a Rule that clearly and unambiguously achieves the goal of improving corporate governance. These lessons include: (1) the need to have a clear purpose which coincides with the Rule's construction; (2) the ability to opt-out should be offered as a fail-safe mechanism against unforeseen costs and to allow some degree of private ordering; (3) the ownership threshold should

balance the need to protect well-managed companies and target those that are poorly managed; (4) requiring shareholders to comply with a holding period is a poor indication of long-term intent and is self-defeating; (5) private ordering which results in stronger governance standards should not be abrogated by the Rule; and (6) care should be taken to account for conflicts of interest among institutional investors.

Not only would drawing upon these lessons make for a better Rule, it would also improve the SEC's ability to conduct a concrete and convincing analysis of the Rule's impact. With a thoughtful and properly conceived new Rule 14a-11, improved governance is possible. What follows is improved economic performance for numerous corporations throughout the United States, regardless of a company's state of incorporation.