provide for free transferability of shares as the default regime for at least one class of corporations (sometimes referred to as "open" corporations).

Free transferability is a default provision. If investors see value in agreeing to restrictions on transfer, all jurisdictions provide mechanisms for permitting agreements to that effect. Sometimes this is done by means of a separate statute, such as the special European statutes for closely held (or close) corporations; sometimes it is done by providing for restraints on transferability as an option under a single general corporation statute, as in the United States.

Additionally (as Easterbrook and Fischel also point out), the free transferability of stock complements centralized management in the corporate form by serving as a potential constraint on the self-serving behavior of the managers of widely held companies.[39] If the stock market distrusts the current management of a company, its share price will fall, and its managers are more likely to be replaced—either because its existing shareholders will throw out the board of directors or because an acquirer will find it financially attractive to take over the company. (As we discuss below in Chapter 13, which deals with control offers, the threat of a takeover can be an important motivator for incumbent managers.) Antitakeover defenses that limit the ability of shareholders to sell their stock to would-be acquirors are controversial among scholars and other corporate governance experts, largely because these defenses restrict the power of the market to discipline managers by transferring control to a new management team.

3.5 Centralized Management

Effectively deploying complex technology in large competitive markets requires continuous investment in specialized information and skills. A great advantage of the corporate form is the creation of the institution of centralized management, which can achieve economies of scale in knowledge of the firm, its technologies and markets. Thus under modern corporate law shareholder designated boards of directors, not investors, are accorded the power to initiate corporate transactions and manage the day-to-day affairs of the corporation. But the powerful innovation of centralized management also gives rise to the principal problem of modern corporate governance for publicly financed firms. Freed of the need to invest in information about the firm and protected by cheap diversification of risk, investors become rationally apathetic. Thus among the foundational problems for modern corporate law is the determination of the set of legal rules and remedies most likely to ensure that these managers will strive to advance the financial interests of investors *without* unduly impinging on management's ability to manage the firm productively.

39. Of course, partners in a general partnership have a different kind of protective "transfer" right that shareholders lack: the power to force dissolution and liquidation of the business. While free transferability is characteristic of corporate shares, it is not mandatory. Close corporations often restrict the free transfer of their stock, which U.S. corporate law allows as long as conspicuous notice appears on the face of the certificate evidencing the share of stock. See, e.g., DGCL §202.

There are at least three aspects of this problem. First, what can the law do to encourage managers to be diligent, given that shareholders — not judges — choose the directors who designate managers. Second, how can the law assist shareholders in acting collectively vis-à-vis managers, especially in the case of widely held companies with many small shareholders? Corporate law cannot eliminate this "collective action problem," as it is termed, but the law can mitigate it by specifying when shareholder votes are required, what information shareholders must be given,[40] and that shareholders must be able to vote in convenient ways that do not require physical attendance at a shareholders' meeting. Third, how can the law encourage companies to make investment decisions that are best for shareholders (and therefore, under most states of the world beneficial for society as a whole)?

Corporate law attempts to mitigate the agency problem in a number of ways. Its main technique is to require, as a default rule, that management be appointed by a board of directors that is elected by the holders of common stock in the company. This centralized directorate structure is, to be sure, a basic feature not only of corporations, but also of large firms generally. (It is typical of accounting partnerships, for example, and even large law firms.) Nevertheless, the corporate form is unique in two respects: First, it makes the centralization of management power in the board a strong default option for firms organized as corporations; and second, by contrast, it vests more power in the board than even large partnerships commonly do. Consider, for example, the typical statutory formulation set forth in §141 of the DGCL:

> (a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.

As we previously stated, the details of the board's structure and decision-making procedure are found in a company's charter or bylaws. Generally, however, the board "acts" by adopting resolutions at duly called meetings that are recorded in the board's minutes. The board appoints a firm's officers and is therefore formally distinct from the operational managers of the company. Legally speaking, the corporate officers are agents of the company; on the other hand, corporate law often treats the board as if it were a quasi-principal of the company (although, of course, the board is often thought of as the *economic* agent of shareholders).

The formal distinction between a corporation's board and its management also permits a distinction between the approval of business decisions and their initiation and execution. As a practical matter, initiation and execution are the province of management, whereas monitoring and approval are the province of the board. This separation serves as a check on the quality of

40. Thus, for example, the Securities and Exchange Act requires that certain financial information be publicly filed periodically by covered firms and that the financial data be audited by an independent auditor.

delegated decision making[41] and makes the board a convenient focus for control mechanisms based on the legal duties of directors.

The additional distinction between a corporation's board and its shareholders is, as we have already noted, principally a device for reducing the costs of corporate decision making. Between annual meetings and while in office, the board need not respond to shareholder concerns, which makes sense because, putting aside agency problems, boards in public companies are often much better informed than shareholders about the firm's business affairs. Also, empowering boards to act in opposition to the will of shareholder majorities can provide a check on opportunistic behavior by controlling shareholders vis-à-vis minority shareholders or other constituencies, such as employees or creditors.

Finally, the board is usually elected by the firm's shareholders. A U.S. corporation may issue nonvoting stock or, at the opposite extreme, accord voting rights to its bondholders. Nevertheless, few companies modify the general default rule that all stock votes at a ratio of one vote per share, and bondholders are never accorded voting rights except by contract when there is a default of interest payments. The obvious utility of restricting the franchise to holders of common stock is that it helps to ensure that the board will act in the interests of the company's owners, that is, its residual claimants.

3.5.1 Legal Construction of the Board

3.5.1.1 The Holder of Primary Management Power

In the United States, corporate law makes the board the ultimate locus of managerial powers. More specifically, board members are not required by duty to follow the wishes of a majority shareholder; thus, the corporation has a republican form of government, but it is not a direct democracy. Is this what the shareholders want? Consider the following English case from early in the last century.

AUTOMATIC SELF-CLEANSING FILTER SYNDICATE CO., LTD. v. CUNNINGHAME

2 Ch. 34 (Eng. C.A. 1906)

[Plaintiff McDiarmid, who, together with his friends, held 55 percent of the shares of the Automatic Self-Cleansing Filter Syndicate Co., Ltd., wished to sell the company's assets. The articles of the company provided that "the management of the business and the control of the company shall be vested in the directors, subject nevertheless . . . to such regulations . . . as may from time to time be made by extraordinary resolution" (i.e., vote of 3/4 of the sharehold-

41. See Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & Econ. 327 (1983).

ers). At a special shareholders' meeting, a resolution to sell the company's assets failed by a vote of 55 percent in favor to 45 percent opposed. Plaintiff then asked the court to order the board to proceed with a sale of assets on specific terms. This request was denied.]

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. . . At a meeting of the company a resolution was passed by a majority — I was going to say a bare majority, but it was a majority [of shareholders] — in favor of a sale [of the company's assets] to a purchaser, and the directors, honestly believing, . . . that it was most undesirable in the interests of the company that that agreement should be carried into effect, refused to affix the seal of the company to it, or to assist in carrying out a resolution which they disapproved of; and the question is whether under the memorandum and articles of association here the directors are bound to accept, in substitution of their own view, the views contained in the resolution of the company. . . .

[I]n the matters referred to in article 97(1.) [of the company law], the view of the directors as to the fitness of the matter is made the standard; and furthermore, by article 96 they are given in express terms the full powers which the company has, except so far as they "are not hereby or by statute expressly directed or required to be exercised or done by the company," so that the directors have absolute power to do all things other than those that are expressly required to be done by the company, and then comes the limitation on their general authority — "subject to such regulations as may from time to time be made by extraordinary resolution." Therefore, if it is desired to alter the powers of the directors that must be done, not by a resolution carried by a majority at an ordinary meeting of the company, but by an extraordinary resolution. In these circumstances it seems to me that it is not competent for the majority of the shareholders at an ordinary meeting to affect or alter the mandate originally given to the directors, by the articles of association. It has been suggested that this is a mere question of principal and agent, and that it would be an absurd thing if a principal in appointing an agent should in effect appoint a dictator who is to manage him instead of his managing the agent.

I think that that analogy does not strictly apply to this case. No doubt for some purposes directors are agents. For whom are they agents? You have, no doubt, in theory and law one entity, the company, which might be a principal, but you have to go behind that when you look to the particular position of directors. It is by the consensus of all the individuals in the company that these directors become agents and hold their rights as agents. It is not fair to say that a majority at a meeting is for the purposes of this case the principal so as to alter the mandate of the agent. The minority also must be taken into account. There are provisions by which the minority may be over-borne, but that can only be done by special machinery in the shape of special resolutions. Short of that the mandate which must be obeyed is not that of the majority — it is that of the whole entity made up of all the shareholders. If the mandate of the directors is to be altered, it can only be under the machinery of the memorandum and articles themselves. I do not think I need say more.

[Judge Collins goes on to observe that there would be no point to requiring a "special resolution" — that is, a 75 percent vote — for removal of directors in the company's charter if the company could be sold by majority vote at a general shareholders' meeting over the objection of the board.]

In a concurring opinion, COZENS-HARDY, L.J., said:

I am of the same opinion. It is somewhat remarkable that in the year 1906 this interesting and important question of company law should for the first time arise for decision, and it is perhaps necessary to go back to the root principle which governs these cases under the Companies Act, 1862. It has been decided that the articles of association are a contract between the members of the company *inter se.* That was settled finally by the case of *Browne v. La Trinidad*, 37 Ch. D. 1, if it was not settled before. We must therefore consider what is the relevant contract which these shareholders have entered into, and that contract, of course, is to be found in the memorandum and articles. I will not again read articles 96 and 97, but it seems to me that the shareholders have by their express contract mutually stipulated that their common affairs should be managed by certain directors to be appointed by the shareholders in the manner described by other articles, such directors being liable to be removed only by special resolution. If you once get a stipulation of that kind in a contract made between the parties, what right is there to interfere with the contract, apart, of course, from any misconduct on the part of the directors? There is no such misconduct in the present case.

. . . If you once get clear of the view that the directors are mere agents of the company, I cannot see anything in principle to justify the contention that the directors are bound to comply with the votes or the resolutions of a simple majority at an ordinary meeting of the shareholders. I do not think it is true to say that the directors are agents. I think it is more nearly true to say that they are in the position of managing partners appointed to fill that post by mutual arrangement between all the shareholders. So much for principle. On principle I agree entirely with what the Master of the Rolls has said, agreeing as he does with the conclusions of Warrington, J.

. . . For these reasons I think that the appeal must be dismissed. . . .

QUESTIONS ON AUTOMATIC SELF-CLEANSING FILTER SYNDICATE

1. Are there good reasons why investors might prefer a rule that requires a supermajority vote in order to override a board decision? Do these reasons apply equally well to all types of decisions?

2. Could the majority of shareholders of a Delaware corporation sell the company's assets without the concurrence of the board? See DGCL §271. Note that, if the board thwarts the will of a majority of the shareholders, the shareholders have a variety of avenues open to them, including passage of a resolution to remove directors at a special shareholders' meeting—or, in some jurisdictions, by consent solicitation.

3. Even with shareholders' right to remove directors, the U.S. approach allocates more power to the board than most other jurisdictions, including

the U.K. and most of Continental Europe.[42] Under many company law statutes, the general shareholder meeting is explicitly recognized as the "highest managerial organ," able to countermand the board on any decision.[43] Can this difference be explained by the fact that U.S. companies tend to be widely held, while European companies more often have concentrated shareholder ownership? And if so, how?

Although the board of directors has the primary power to direct or manage the business and affairs of the corporation (e.g., DGCL §141), it rarely exercises nitty-gritty management power. Instead, it designates managers or, more realistically, a chief executive officer, who, in turn, nominates other officers for board confirmation. But the managerial powers of directors, acting as a board, are extremely broad. Beyond the powers to appoint, compensate, and remove officers, they include the power to delegate authority to subcommittees of the board, to officers, or to others; the power to declare and pay dividends; the power to amend the company's bylaws; the exclusive power to initiate and approve certain extraordinary corporate actions, such as amendments to the articles of incorporation, mergers, sales of all assets, and dissolutions; and more generally, the power to make major business decisions, including deciding the products the company will offer, the prices it will charge, the wages it will pay, the financing agreements it will enter, and the like.

3.5.1.2 Structure and Function of the Board

The charter may, but customarily does not, provide much structure for the board. It will often set an upper limit on size and allow bylaws or board resolutions to do most of the rest of the work. In default of any special provisions in the charter, all members of the board are elected annually to one-year terms. The charter may provide that board seats are to be elected by certain classes of stock. For example, Class A common stock may elect one-third of the members of the board, while Class B elects the rest. In such situations, however, all directors still owe their fiduciary duty to the corporation as an entity and to *all* its shareholders: Specially elected directors do not owe a particular duty to the class that elected them. All directors have one vote on matters before the board.

The board has inherent power to establish standing committees for the effective organization of its own work, and it may delegate certain aspects of its task to these committees or to ad hoc committees. Insofar as committees

42. The primary exception is Germany, where the codetermination law allocates half of the board seats in large companies to employee representatives. In the case of a tie vote, the chair — a shareholder representative — is allowed a decisive second vote.

43. See Henry Hansmann & Reinier Kraakman, The Basic Governance Structure, in Reinier Kraakman et al. eds., The Anatomy of Corporate Law: A Comparative and Functional Approach (2004).

6

NORMAL GOVERNANCE: THE VOTING SYSTEM

6.1 Introduction: Shareholder Voting in the New Corporate Governance

Much of the utility of the corporate form derives from the broad discretion that it delegates to a centralized management structure. Yet that discretion is not absolute. It is restricted by statute in several important ways and may be curtailed by the corporate charter (and perhaps by bylaws — a complicated subject that is reserved for later). But remarkably few public companies do restrict the board's managerial power in their charters. Instead, equity investors in public corporations rely largely on the default terms built into corporation law to control the agency costs of management.

Professor Robert Clark has aptly summarized these default powers of shareholders as three: the right to vote, the right to sell, and the right to sue. Stated more fully, shareholders have the power to elect the board of directors and to vote upon the most fundamental corporate transactions; they have the right to sell their stock if they are disappointed with their company's performance; lastly, they have the right to sue their directors for breach of fiduciary duty in certain circumstances. It is important to recognize, however, that each of these shareholder strategies for disciplining management interacts with the others. Thus, the investor's power to sell her stock may facilitate a hostile takeover of an underperforming firm, but the effectiveness of a takeover attempt may, in turn, depend on the ability to conduct a proxy fight for shareholder votes. Likewise, the effectiveness of a proxy fight may be impaired by management actions that shareholders can attack in court as a breach of fiduciary duty. Although we analyze these basic rights separately, in practice they work together.

In this Chapter, we address the shareholders' most basic voting right: the right to elect the board of directors. We also touch on many associated topics, including calling annual meetings, voting for and removing directors, affording information to shareholders, voting by proxy, and judicial superintendence of shareholder voting. In aggregate, these topics cover the "normal governance" machinery of the corporation. We reserve for later chapters detailed consideration of the law bearing on proxy contests and on shareholder rights to vote on fundamental transactions: for example, an amendment of the charter, a merger, a sale of all assets, or a dissolution.[1] These topics are addressed in Chapters 12 and 13.

The most important factor affecting shareholder voting is the collective action problem faced by shareholders in large public companies. Consider two extreme cases. In the first, the corporation's shares are all owned by a single shareholder. There are no costs of collective shareholder action in this case. Indeed the voting system is merely a formality because the shareholder appoints directors at her pleasure. Whether the corporation's managers enjoy any discretion depends entirely on how closely our shareholder-principal decides to monitor their performance. (A single owner who was temperamentally inclined to confer no discretion on agents would necessarily have to limit the size of her organization.)

In the second extreme case, assume that shares in the corporation are held by 100,000 shareholders, each with a $100 investment. In this case, informed shareholder action (vote) would require that some investment in information be made by a very large number of shareholders. This would be collectively and individually costly. Any one shareholder's prospective share of the potential benefit that informed vote *might* produce would probably not justify her personal costs. But more important, any one shareholder's vote *is quite unlikely to affect the outcome* of the vote. Thus, since becoming informed takes effort, and a shareholder will get the same proportionate share of any benefit the vote may produce, whether she invests in becoming informed and voting intelligently or not, economically, her incentive is to remain passive. Conversely, the larger a shareholder's proportionate stake is, the greater the probability that her vote will affect the outcome and the less she suffers from this problem of "rational apathy." But for our stylized firm of 100,000 equal shareholders, the shareholder collective action problem would preclude informed shareholder action; rational shareholders would be highly unlikely to challenge board decisions or even inform themselves about the company's performance beyond following the price of its stock. Thus, in this polar case, too, the voting system might largely be seen as a formality.

In the past, commentators tended to treat most American corporations as representative of one or the other of these extremes. Indeed, since Professors Adolf Berle and Gardner Means first confirmed the rise of a seemingly autonomous managerial class in the 1930s,[2] the second case (that of the diffusely held company with a passive shareholder base) has been the conventional model of the large American public corporation. Commentators have not always thought this arrangement of passive shareholding was optimal, however, and attempts have been made to create a more active "shareholder democracy." Most notably, the 1934 Securities and Exchange Act sought to reduce this collective action problem through mandated disclosure of information (see the discussion of §14 of the 1934 Act below), and the courts

1. See, e.g., DGCL §242 (charter amendment), §251 (merger), §271 (sale of substantially all assets), and §275 (dissolution).

2. Adolf Berle & Gardner Means, The Modern Corporation and Private Property (1932).

have tended to aid this process by implying private remedies under that Act. The Securities and Exchange Commission (SEC), acting under the color of §14, has promulgated elaborate proxy rules designed to encourage informed shareholder voting. Ironically, until their amendment in 1992, these rules, by increasing the cost associated with shareholder communication, may have encouraged even greater voting passivity among shareholders.[3]

But not everyone agrees that mandated disclosure makes shareholders effective monitors. Some economically oriented commentators have argued that the collective action problem is fatal in diffuse public capital markets no matter how much information is available. These commentators have argued that managers are constrained not by shareholder votes but by the pressures exerted by multiple markets: the product market, the market for managerial services (including compensation incentives), the capital market (which must be accessed for funds), and most dramatically, the market for corporate control.[4]

Despite widespread academic pessimism about the inevitability of shareholder passivity, a new shareholders' rights movement led by institutional investors holding large blocks of shares emerged at the end of the 1980s. This movement was aided by a 1992 amendment by the SEC of its proxy rules, which permitted communication between large investors relating to forthcoming corporate votes without filing costly proxy solicitation materials, as had earlier been required. This movement has gradually transformed much of the practice of corporate governance in the United States.

No one in the 1960s or 1970s could have foreseen the current terrain of corporate governance. They would not have expected the upheavals of the 1990s, in which, under pressure from institutional shareholders, boards of directors of such leading firms as General Motors, IBM, Sears, Westinghouse, and American Express fired CEOs who were once thought to hold impregnable positions. Nor could they have imagined the speed of change in corporate governance practices during the period of 2000-2014. In that brief period, pressure from shareholder interests has effectively (1) required a change to majority of independent directors on boards of public companies, (2) successfully promoted the widespread change of the standard for electing directors from plurality to majority of shares voting in uncontested elections, (3) successfully promoted the widespread (but not universal) abandonment of staggered board structures, (4) advocated for the frequent splitting of the board chair position from that of CEO (although this has only affected a minority of firms), (5) successfully begun the process of gaining access by shareholders to the company's own proxy statement on a company-by-company basis, (6) successfully promoted the adoption of a mandatory shareholder advisory vote on executive compensation, and (7) facilitated greater openness on the part of outside directors to communicate with institutional shareholders. We will

3. For a useful study of successive revisions to the proxy rules and their depressing effects on shareholder participation in governance, see John Pound, *Proxy Voting and the SEC*, 29 J. Fin. Econ. 241 (1991).

4. See, e.g., Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & Econ. 301 (1983).

touch upon many of these topics in this Chapter or elsewhere in this book. See especially §6.8, dealing with the evolution of activist hedge funds, §6.9.2, treating their use of the "short slate" proxy contest, and §6.9.3, dealing with shareholder access to the company's proxy in order to nominate individuals for the board of directors. Cumulatively, these and other changes have had a transformative effect on how elected corporate boards approach their responsibilities. It may not be excessively dramatic to call this the age of the new corporate governance.

Thus, we no longer live in a world of extreme cases in which collective action costs are either nonexistent (because the corporation has a controlling shareholder) or preclusive (because stockholding is highly diffuse). Instead, growing institutional portfolios, freer communication between institutions, and the evolution of new agents of investors (including Institutional Shareholder Services)[5] have created ownership and coordination structures that fall between these two extremes. Perhaps most dramatically, agents of market discipline in the form of activist hedge funds have emerged over the last ten years to deploy the new governance tools, putting virtually every board of directors of a public company in the United States on alert. In today's modal public corporation, collective action costs continue to be significant but not large enough to preclude shareholders from monitoring and even sometimes redirecting managerial performance. The stockholders' right to vote is the ground upon which the new corporate governance is erected and thus the law establishing and regulating its exercise is vitally important both for the typical public corporation today and for those purporting to act for shareholders.

6.2 Electing and Removing Directors

6.2.1 Electing Directors

This is the foundational — and mandatory — voting right. Every corporation *must* have a board of directors, even if the "board" has only a single member. DGCL §141(a). And every corporation must have at least one class of voting stock. Indeed, in the absence of any customization in the charter, each share of stock has one vote — no more, no less. DGCL §212(a). However, the legal mandate that there be *some* voting stock is in fact a trivial constraint on governance design. It is possible to create nonvoting common stock and a single class of voting stock containing a single share. Of course, such one-class,

5. Institutional Shareholder Services (ISS) is a powerful for-profit organization that provides proxy voting advice to institutional shareholders and corporate governance advice to major companies, among other services. On hotly contested issues (e.g., takeover contests, or, more recently, majority voting proposals) ISS's recommendation can sometimes determine the outcome. One study estimates that ISS's recommendation on "Say on Pay" advisory votes swung the outcome by 20 percentage points, on average, in 2011. See Latham & Watkins Corporate Governance Commentary (Sept. 2011) at 3. For more information on ISS, see their web site, www.issgovernance.com. See also the web site of competing proxy adviser Glass Lewis at www.glasslewis.com.

one-share voting stock is never encountered in practice. Rather, in publicly financed corporations, most equity takes the form of voting common stock.

Why does almost all common stock carry voting rights? The sensible explanation is that the right to appoint the board of directors is more valuable to common stock investors than to any other class of investors. Their security has no maturity date and no legal right to periodic payments. Thus, they have a greater need for the default protection of voting rights than other investors in the enterprise. Bondholders are protected by a hard contractual right to interest payments and to the return of their principal, usually on a stated maturity date and sometimes secured with property of the debtor. It follows that the default right to choose or replace the board is much more important for common stock to possess than for bondholders or other investors in the corporation. In those uncommon cases in which one class of common stock is nonvoting, its holders must in effect free ride on the governance incentives of the voting common stock.

Another mandatory feature of the voting system is the *annual* election of directors.[6] Each year, holders of voting stock elect either the whole board, when there is a single class of directors, or some fraction of the board. For example, shareholders elect one-third of the board annually when the charter provides for a "staggered" or "classified" board made up of three "classes" of directors, each serving three-year terms. See DGCL §141(d). At the annual meeting, directors are duly elected should they receive that number of affirmative votes stated in bylaws or charter. Under the DGCL, the vote required to elect a director may be fixed in the charter or in bylaws, but in default of any express requirement stated in those documents, candidates are elected if they receive a plurality of votes at a meeting with a quorum (DGCL §216). Importantly, the Delaware statute, as recently amended, specifically provides that the board may not amend or repeal a stockholder-adopted bylaw fixing that vote requirement. Thus shareholders of Delaware companies have the express power to fix a majority of votes cast as the election rule and a large majority of public corporations have now done so in cases of uncontested elections.[7]

Corporate law facilitates the election of directors by creating a flexible framework for holding the annual meeting of shareholders. Generally, the state statutes fix a minimum and maximum notice period (e.g., 10-60 days, DGCL §222(b)) and a quorum requirement for the general meeting (e.g., DGCL §216). The statutes also establish a minimum and maximum period for the board to fix a so-called record date. Shareholders who are registered as shareholders as of the record date are legal shareholders entitled to vote at the meeting (e.g., DGCL §211(c)). Within the range of alternatives permitted by

6. See DGCL §211. In non-U.S. jurisdictions, directors' terms are frequently longer; for example, four years in Germany and six years in France. Closely held private corporations in the United Kingdom occasionally elect directors *for life*. In all of these cases, however, shareholders retain a mandatory right to remove directors.

7. In a contested election, usually the nominee with the highest vote prevails. Where a majority vote is required for election and no candidate gets a majority of the vote cast, the incumbent will hold over in office. However, most firms have a policy, insisted on by institutional investors, that the holdover submit his resignation to the board promptly.

statute, a corporation's actual notice period, quorum requirement, and record date will be established in the charter or in a bylaw or, in the case of record date and notice by the board as authorized in those documents.

CUMULATIVE VOTING

The default voting regime is that each shareholder gets one vote for each share of voting stock owned and may cast it for each directorship (or board position) that is to be filled at the election. Thus, if there are seven places on the board to be filled each year, an owner of one share casts one vote for a candidate for each office. This allows the holder of a 51 percent voting block to designate the complete membership of the board of directors, while the holder of a sizable minority block of stock (say, 49 percent) can be entirely excluded from representation on the board. To some, this seems undesirable.

An alternative technique for voting first sprang up late in the nineteenth century. This technique, called *cumulative voting*, is designed to increase the possibility for minority shareholder representation on the board of directors. In a cumulative voting regime, each shareholder may cast a total number of votes equal to the number of directors for whom she is entitled to vote, multiplied by the number of voting shares that she owns, with the top overall vote getters getting seated on the board.

To see how cumulative voting can work, consider a simple example. Family Corp. has 300 shares outstanding. Shareholder A owns 199 shares and Shareholder B owns 101 shares. Family Corp. has a three-person board elected to annual terms. Assume that shareholders A and B support different candidates for the board. Under "straight" voting, A would win each seat 199 to 101. Under cumulative voting, B could cast 303 votes (= 101 shares × 3 seats up for election) all for a single candidate. Thus B would be guaranteed to get one seat on the board, because A's 597 votes (= 199 shares × 3 seats) cannot be divided three ways so that all three of A's candidates receive more than 303 votes. This example illustrates how cumulative voting can allow significant minority shareholders to get board representation roughly in proportion to their shareholdings.

While cumulative voting was popular among certain shareholders during the first half of the twentieth century, it was never popular with managers, who argued that boards are collegial organizations that function best cooperatively. Boards with divided shareholder allegiances were said to be too adversarial. Thus, few companies have adopted cumulative voting during the last fifty years, even as a default option.[8] Where a corporate charter does mandate cumulative voting, however, it affects the exercise of the shareholder removal rights (since it obviously makes little sense to permit a straight majority vote to remove a director without cause when he or she was elected by a cumulative vote).

8. See Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 Colum. L. Rev. 124 (1994).

6.2.2 Removing Directors

State corporate law governs not only the right to elect directors, but also the right to remove them. Under the DGCL, shareholders may remove directors from office at any time and for any reason, except in the case of "staggered boards" in which case they may do so only "for cause," unless the charter provides otherwise. DGCL 141(k). Removal may be accomplished at a shareholders' meeting or by action of written consent, as explained below.

When a board is staggered (DGCL §141(d)), removal is more difficult. The leading case, *Campbell v. Loew's Inc.*,[9] establishes that a director is entitled to certain due process rights when he or she is removed for cause, although just what these rights include, and who decides when they are violated, remains unclear. Equally important, it is not clear what constitutes "good cause." Certainly, fraud or unfair self-dealing is cause to remove a director, but what about abysmal business judgment? If one views the directorship as a sort of property right, which seems to be predicate of the "cause" requirement, then poor business judgment, without additional faults, would not constitute cause for removal. See DGCL §141(k), conferring broad removal power on shareholders.

State law in most jurisdictions, including Delaware, bars directors from removing fellow directors, for cause or otherwise, in the absence of express shareholder authorization. This means, for example, that a board typically cannot adopt a bylaw that purports to authorize it to exercise a removal power. Some statutes, however, do permit shareholders to grant the board power to remove individual directors for cause. See, e.g., NYBCL §706. In all events, if the board uncovers cause for removal, it can petition a court of competent jurisdiction to remove the director from office. Although some courts have expressed doubt about their power to remove a director during her term, it is generally conceded that any court of equity supervising the performance of any fiduciary has an inherent power to remove for cause. Ordinarily, state courts of the jurisdiction of incorporation must exercise this power because the law of the state of incorporation governs a corporation's internal affairs. However, federal courts have this authority as well when the corporation is publicly traded, and therefore registered under the Securities and Exchange Act of 1934.

PROBLEM: THE UNFIREABLE CEO

Village, Inc. is a corporation engaged in the business of providing online fashion advice and consulting services to male law students and young lawyers. The firm had its initial public offering (IPO) two years ago, and after a meteoric rise, the stock has fallen steadily since then. GianCarlo Morrison, who is Village's CEO, owns 25 percent of its single class of stock. The balance of the stock is widely held. Morrison's block has allowed him to control the outcome of board elections. The bylaws specify that the number of directors shall be fixed at nine and divided into three equal classes, each of whose term shall expire in successive years. The word on the street, however, is that the nosedive of the stock has sparked the interest of others in gaining control. Under these circum-

9. 134 A.2d 852 (Del. Ch. 1957).

Putting the matter of meetings in the corporate charter allows corporate planners to decide for themselves in particular cases. The Revised Model Business Corporation Act (RMBCA) offers a typical solution. Under §7.02, a corporation must hold a special meeting of stockholders if (i) such a meeting is called by the board of directors or a person authorized in the charter or bylaws to do so, or (ii) the holders of at least 10 percent of all votes entitled to be cast demand such a meeting in writing. Delaware law has no such mandated minimum; it provides that special meetings may be called by the board or by such persons as are designated in the charter or bylaws. See DGCL §211(d).

Shareholder Consent Solicitations. Shareholders may have an alternative to special meetings in the form of a statutory provision permitting them to act in lieu of a meeting by filing written consents. Delaware was an innovator in establishing this alternative technique for shareholder action, although at the time it was adopted, it was thought to be little more than a cost-reducing measure for small corporations. As we will see later, however, this mechanism can also assist in hostile takeovers where acquirers wish to displace the boards of public companies.

The stockholder consent statute in Delaware provides that *any action* that may be taken at a meeting of shareholders (e.g., amendment of bylaws or removal of directors from office) may also be taken by the written concurrence of the holders of the number of voting shares required to approve that action at a meeting attended by all shareholders. See DGCL §228. Other states are less "liberal." The RMBCA, for example, requires unanimous shareholder consent. See §7.04(a).

6.4 Proxy Voting and Its Costs

Shareholder meetings require a quorum to act. Given the widely dispersed share ownership of most publicly financed corporations, public shareholders are unlikely to actually attend shareholder meetings. As a result, in order to gather a quorum, the board and its officers are permitted to collect voting authority from shareholders in the form of proxies. In doing so, management acts on behalf of and at the expense of the corporation. In short, proxy voting is fundamental to corporate governance in publicly financed corporations. State corporation law establishes its validity as well as the legal structure in which proxies are given, exercised, and revoked. See, e.g., DGCL §212(b); NYBCL §609. But federal law, particularly Section 14 of the Securities and Exchange Act, regulates a great deal about the solicitation and use of proxies in firms with publicly traded shares. Thus both sources of law may be significant in questions respecting proxy voting.

There is no single form that is mandated for a valid proxy. Generally, proxies must record the designation of the proxy holder by the shareholder and authenticate the grant of the proxy. In traditional terms, this was, and most often still is, a signed "proxy card." Modern statutes do recognize that electronic communications may also be used to designate a proxy, so long as sufficient evidence of authenticity is supplied. See DGCL §212(c)(2).[16] A proxy holder is bound to exercise the proxy as directed. Thus proxies usually include a list of the specific nominees and specific issues on which the proxy holder proposes to vote. In most cases, however, proxy holders may exercise independent judgment on issues arising at the shareholder meeting for which they have not received specific instruction. Proxies, like all agency relationships, are revocable unless the holder has contracted for the proxy as a means to protect a legal interest or property, such as an interest in the shares themselves. See DGCL §212(e); *Haft v. Haft*, 671 A.2d 413 (Del. Ch. 1995) (proxy held by CEO was irrevocable because of proxy holder's interest as officer of the corporation).

Under SEC regulations the practice is that management supplies a proxy card to shareholders for them to sign and return. This card will list management's nominees. Should there be a contest, the insurgents will furnish their own card listing their nominees. Under current practice shareholders do not mix and match nominees. A shareholder will pick and sign one proxy card or the other. The last proxy card she signs and submits will revoke any earlier one. There has been some discussion for years about the SEC approving a "universal" proxy card, which would allow shareholders in a contest to mix and match their votes. Recently, the Council of Institutional Investors petitioned the SEC to adopt a rule change that would permit use of a universal proxy card, which would permit a shareholder in a contest to select on a single card some nominees from the incumbent slate and some from the insurgent slate.[17] Can you identify possible policy benefits or risks of such a change?

While proxy voting allows public shareholders to "meet," and reduces their collective action problem, it does not eliminate it. In particular, proxy voting relies on one or more persons to incur the initial expenses of soliciting proxies. Since these costs are substantial, a serious impediment to collective action still exists.

On one hand, the costs of soliciting proxies are a matter of normal governance because subsidizing these costs from the corporate treasury is essential for the operation of annual shareholder meetings. In the normal governance setting, management must be allowed to expend corporate funds to call annual meetings and solicit proxies, otherwise in corporations with publicly traded stock, shareholder rational passivity would make annual meetings impossible. On the other hand, authorizing the board to expend corporate funds on its own re-election seems to permit a kind of self-dealing. Specifically, in proxy fights for corporate control (see §13.8) it gives the incumbent board a financial advantage over others. This raises the question whether the law ought to encourage insurgent shareholders to solicit proxies by mandating the reimbursement of their reasonable expenses as well. Of course, any

16. See also the "Eproxy rules," SEC Rule 14a-16, requiring all public companies to post their proxy materials on a publicly available web site, and requiring a mail "Notice of Internet Availability of Proxy Materials." The rule adopted in 2007 has not yet revolutionized practice.

17. See, http://www.corporatesecretary.com/articles/proxy-voting-shareholder-actions/12624/cii-petitions-sec-universal-proxy-cards/.

particular company could put a provision in its charter or bylaws, reimbursing insurgent costs. Delaware law specifically permits shareholders or the board to enact a bylaw doing so (see DGCL §113). But few companies have adopted such bylaws, perhaps in part because it would not be in the interests of management to do so but also because it is not clear ex ante that more of these contests (or how many of them) would be efficient.

PROBLEM: ONLY INCUMBENTS AND WINNERS GET FREE PROXIES

A group of dissident shareholders controls 20 percent of the voting shares of Incumbent Air, a poorly run airline catering to corporate executives. Suppose that the dissidents believe they stand a 50 percent chance of winning a proxy fight and that they will spend $2 million in mobilizing shareholder support, as will the incumbent managers. Assume that management can use the corporate purse to pay the costly expenses of the proxy battle.

If the dissidents have to pay their own legal and other proxy expenses out of pocket, under what circumstances will they actually go through with the proxy fight (assuming they are risk-neutral, rational profit-maximizers)? What is the total gross gain in corporate value that the dissidents must expect before they will initiate a proxy contest? What effect would there be if the dissidents were reimbursed for their proxy expenses regardless of the outcome?

ROSENFELD v. FAIRCHILD ENGINE & AIRPLANE CORP.
128 N.E.2d 291 (N.Y. 1955)

FROESEEL, J.:

In a stockholder's derivative action brought by plaintiff, an attorney, who owns 25 out of the company's over 2,300,000 shares, he seeks to compel the return of $261,522, paid out of the corporate treasury to reimburse both sides in a proxy contest for their expenses. The Appellate Division has unanimously affirmed a judgment of an Official Referee dismissing plaintiff's complaint on the merits, and we agree. Exhaustive opinions were written by both courts below, and it will serve no useful purpose to review the facts again.

Of the amount in controversy $106,000 were spent out of corporate funds by the old board of directors while still in office in defense of their position in said contest; $28,000 were paid to the old board by the new board after the change of management following the proxy contest, to compensate the former directors for such of the remaining expenses of their unsuccessful defense as the new board found was fair and reasonable; payment of $127,000, representing reimbursement of expenses to members of the prevailing group, was expressly ratified by a 16 to 1 majority vote of the stockholders.

The essential facts are not in dispute. . . . By way of contrast with the findings here, in *Lawyers' Adv. Co. v. Consolidated Ry. Lighting & Refrig. Co.* (187 N.Y. 395), which was an action to recover for the cost of publishing

Dual-class voting structures can solve a specific problem for new, fast-growing businesses. These entrepreneurial firms often depend on the vision and dedication of a entrepreneur and her small team of associates. It is they who had the original concept, implemented it, and built a business. As it succeeds, the firm needs more capital to fund growth. Banks and credit markets can supply credit, but if growth is fast more capital will be needed shortly. At some point, creditors will begin to feel a need for greater equity cushion. However, further issuance of shares — if the growth is great enough and need for capital high — will begin to threaten the entrepreneur's control. She may rationally believe that her vision and dedication (control) is essential for the business's long-term success. (This can be delusion or fact, it doesn't matter.) Wanting to maintain control, the entrepreneur has a choice: risk loss of control by issuing more shares or slow or stop growth to ensure continued control. Dual-class shares are one answer to this problem. The entrepreneur can cause the firm to offer low vote or non-voting shares in its IPO. If the market likes what the entrepreneur and her team have done and expects them to continue, the market will price the securities. Will it discount them because of this structure? Maybe. Or it may pay a premium in the belief that protecting the brilliant leadership of the entrepreneur is valuable. Or finally, perhaps the market is of two minds. On one hand, protecting the entrepreneur during the company's first stage of rapid growth seems like a good idea; on the other hand, according the same protections to an aging entrepreneur who will still lead the company two decades after its IPO might not seem like a good idea. Theory can't tell us how the costs and benefits net out.[27]

However, dual-class structures are problematic when they are adopted in "midstream," after the firm's shares are already publicly trading. They can be adopted midstream only by a charter amendment requiring a shareholder vote. But such a vote might not protect public shareholders who face a collective action problem.[28] Those proposing a dual-class voting structure can exploit the collective action problem by offering public shareholders a minor benefit in consideration for accepting diluted voting power. For example, the corporation might exchange one share of the old common stock for one share of new Class A common stock or one share of new Class B common stock. The Class A will have all of the rights of the old common stock plus its holders will receive a one-time special dividend (say, 50 cents a share). The new Class B stock will have those same rights except (1) it has no right to a special dividend, (2) it has ten votes per share, and (3) whenever it is transferred (except by death or inter vivos gift to a family member), it will automatically be converted into the same number of Class A common shares.[29]

27. Empirical studies can help, but the answer they will give will be aggregate; that is, if the studies are good, they can show what the structure has produced on average (over a certain data set), somehow calculated (i.e., weighted by market cap or not).

28. See Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 Calif. L. Rev. 1 (1988); Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 Va. L. Rev. 807 (1987).

29. See, e.g., *Lacos Land Company v. Arden Group, Inc.*, 517 A.2d 271 (Del. Ch. 1986) (injunction against shareholder vote on management's effort to amend charter in a similar way; basis was that management wrongfully coerced the vote by threatened breach of duty if approval was not forthcoming). Compare *Blasius Corp v. Atlas*, in Chapter 12.

The result, of course, is that a controller or management soon accumulates control over the company. Might such a transaction be efficient? Perhaps so, although one suspects that most managers who propose midstream charter amendments hope to extract value from shareholders.

In 1986, in response to NASDAQ listing requirements that permitted dual-class structures, the NYSE proposed to amend its rules to permit such structures as well. A howl of protest met the proposal, and the SEC, under its statutory authority to regulate securities exchanges, enacted Rule 19c-4, which effectively prohibited both the NYSE and NASDAQ from listing shares with unequal voting rights unless initially offered to the market in that structure. The D.C. Circuit Court of Appeals subsequently struck down Rule 19c-4 as constituting unauthorized regulation of internal corporate governance matters. See *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990). The matter was thereafter resolved by an informal agreement among the NYSE, NASDAQ, and SEC to amend listing rules to proscribe securities that limit the voting rights of existing securities but to permit initial public offerings of low-vote or no-vote stock that do not control the rights of existing stock. So since that time dual-class structures can only be be listed at the time of the firm's IPO.

6.8 Mitigating a Collective Problem Today: Activist Investors

Even with the many changes in corporate governance we have observed recently (§6.1), change still requires a shareholder to initiate board interaction. In instances in which business policy or practices (not just governance practices) are sought to be changed, this role is usually filled by a hedge fund (i.e., investment fund that is lightly regulated and not required, as mutual funds are, to diversify its investment portfolio). Despite their vast size, even the largest institutional investors (think Vanguard Funds, Black Rock or Fidelity) must be highly diversified and face completive incentives that limit how active they will be in monitoring the business performance of portfolio companies. But these mutual fund managers can empower activist hedge funds to do so by selectively supporting their efforts.[30]

Over the period 2010-15, activist hedge funds have become increasingly significant. Their investment strategies differ of course, but in general they investigate opportunity, do sophisticated analysis, and acquire a substantial position in only a handful of target companies. Their strategy can be as simple as seeking to dividend excess cash on the balance of that company, or as complex as split-off or spin-off transactions or a sale of the company. They rarely if ever want to take over control and management of the business. Once they have their investment position (often amplified with derivatives) the activist

30. For a thoughtful panorama of this landscape, see Ronald Gilson & Jeffrey Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 Col. L. Rev. 863 (2013).

will approach the CEO or the board to begin to lobby or even agitate for the desired changes. In the entirely predictable event that management and the board are not welcoming, their major tool is to threaten a short slate proxy contest. (explained in the discussion of proxy contests, §6.9.2 below).The following excerpt explains why some commentators see these hedge funds as well positions to make positive change.

MARCEL KAHAN & EDWARD B. ROCK, HEDGE FUNDS IN CORPORATE GOVERNANCE AND CORPORATE CONTROL

155 U. Pa. L. Rev. 1021 (2007)

Hedge funds are emerging as the most dynamic and most prominent shareholder activists. On the bright side, this generates the possibility that hedge funds will, in the course of making profits for their own investors, help overcome the classic agency problem of publicly held corporations by dislodging underperforming managers, challenging ineffective strategies, and making sure that merger and control transactions make sense for shareholders. In doing so, the bright side holds, hedge funds would enhance the value of the companies they invest in for the benefit of both their own investors and their fellow shareholders. . . . But the bright-side story of hedge funds — of large and sophisticated investors standing up to management for the benefit of shareholders at large — has an element of déjà vu. Twenty years ago, similar stories were told about another set of large and sophisticated investors: mutual funds, pension funds, and insurance companies — or "institutional investors" as they became known. While, on the whole, the rise of these traditional institutional investors has probably been beneficial, they have hardly proven to be a silver bullet.

Are there reasons to think that the newly prominent hedge funds will be more effective? . . . The incentives for hedge funds to monitor portfolio companies differ in several important respects from those of traditional institutional investors. First, hedge fund managers are highly incentivized to maximize the returns to fund investors. The standard hedge fund charges a base fee equal to 1-2% of the assets under management and a significant incentive fee, typically 20% of the profits earned. This fee structure gives hedge fund managers a very significant stake in the financial success of the fund's investments. These stakes are even higher when, as is frequently the case, a hedge fund manager has invested a significant portion of her personal wealth in the hedge fund.

Secondly, many hedge funds strive to achieve high absolute returns, rather than returns relative to a benchmark. In particular, the industry-standard 20% incentive fee is usually based on a fund's absolute performance. And while a few funds use a hurdle rate before the incentive fee is payable, this hurdle rate is generally a rate based on the yield of debt securities, not based on the performance of a market index or an index of hedge funds with similar investment objectives.

Thus, unlike mutual funds, hedge funds benefit directly and substantially from achieving high absolute returns. For successful managers, the resulting profits can be extraordinary high. The average take home pay for the top 10 hedge fund managers in 2014 [as estimated by Forbes magazine] was $890 million, and the lowest paid manager [among the top 25 hedge fund managers] . . . still earned a respectable $150 million. These figures [were down somewhat from 2013 when the earnings of the top ten hedge fund managers averaged $1,09 billion]. [We have taken the liberty to update the authors earnings to more recent periods.— Eds.]

6.9 The Federal Proxy Rules

Nowhere are one's views on the severity of the collective action problem more salient than in an evaluation of the effects of the federal proxy rules on the operation of the voting system in public companies.

The federal proxy rules originate with the provisions of the Securities Exchange Act of 1934 (the Exchange Act or sometimes the '34 Act), chiefly §14(a)-(c), which regulate virtually every aspect of proxy voting in public companies. These provisions support an array of rules subsequently promulgated and enforced by the Securities and Exchange Commission (SEC).

The federal proxy rules consist of four major elements:

1. Disclosure requirements and a mandatory vetting regime that permit the SEC to assure the disclosure of relevant information and to protect shareholders from misleading communications;
2. Substantive regulation of the process of soliciting proxies from shareholders;
3. A specialized "town meeting" provision (Rule 14a-8) that permits shareholders to gain access to the corporation's proxy materials and to thus gain a low-cost way to promote certain kinds of shareholder resolutions; and
4. A general antifraud provision (Rule 14a-9) that allows courts to imply a private shareholder remedy for false or misleading proxy materials.

In this section, we present, in plain English, a brief overview of the federal proxy rules adopted by the SEC under §14 of the '34 Act. We then present two of the rules in greater detail — Rule 14a-8, the town meeting rule, and Rule 14a-9, the antifraud rule.

6.9.1 Rules 14a-1 Through 14a-7: Disclosure and Shareholder Communication

Unlike company law in EU jurisdictions, corporate law in most U.S. states has never imposed an affirmative obligation on corporations to inform shareholders of the state of the company's business or even to distribute a balance sheet and income statement.[31] At most, shareholders could demand stock lists and sometimes gain access to detailed books and records. Presumably, in an earlier age, the power to replace the board was seen in the United States as a sufficient inducement for firms to disclose. Matters changed, however, after the Great Depression when federal legislation adopted the core strategy of mandating public disclosure. While much of this legislation was designed to inform investors in the initial offer and secondary markets, some of it—in particular, §14(a) of the Securities and Exchange Act of 1934—addressed disclosure in connection with the solicitation of proxies.

Section 14(a) made it unlawful for any person, in contravention of any rule that the commission may adopt, to "solicit" any "proxy" to vote any "security" registered under §12 of the Act. The SEC soon gave each of these terms—"solicit," "proxy," and "security"—a very broad interpretation in Regulation 14A. The basic scheme of the Regulation was (and is) to state with great detail the types of information that any person must provide when seeking a proxy to vote a covered security. These rules were drafted to force disclosure by corporations to the shareholders from whom they sought proxies. These rules, however, apply not only to an issuing corporation but also to a third party who might seek to oust incumbent management by a proxy fight. Thus, they had the unintended consequence of discouraging proxy fights. The 1966 case of *Studebaker Corporation v. Gittlin*[32] illustrates the point. In that case, a request to forty-two stockholders of a large public company to join in a request to inspect the shareholders' list (necessary because, under state law, the list was available only on the demand of more than 5 percent of the company's stock) was held to constitute a "solicitation" of a "proxy" requiring the preparation, filing, and distribution of a proxy statement. By 1990, the risks and expense that the proxy rules imposed on governance activities became the subject of widespread criticism. Consider the following excerpt from an op-ed by Professor Mark Roe:

> Today [December 1991], if a dozen shareholders want to talk to one another about the company that they own, they must file a proxy statement with the SEC, informing it of what they want to say, and usually letting SEC staffers edit their statement. Even a simple newspaper ad usually requires clearance from the SEC. If stockholders have doubts about the quality of their management, they must act publicly, in costly, stilted, potentially embarrassing ways. Publicity instills silence. Why stick your neck out and publicly question management if no one else is going to go along? Before testing whether the water is over your head, you must commit to jumping in. . . . It might seem incredible if during a presidential election, voters could not talk to one another, other than through a formal statement filed with a government agency. But this is the situation in corporate elections.[33]

In 1992, the SEC responded by amending the rules in several important ways. In general, the 1992 amendments to Regulation 14A limited the term

31. There are a few exceptions to this generalization. See, e.g., Mich. Bus. Corp. Act §901, which requires corporations to distribute financial statements to shareholders.

32. 360 F.2d 692 (2d Cir. 1966).

33. Mark Roe, *Free Speech for Shareholders?*, Wall St. J. (Dec. 18, 1991).

"solicitation" in Rule 14(a)-1(l) and created new exemptions under Rule 14(a)-2, which released institutional shareholders, in limited circumstances, from the requirement to file a disclosure form before they could communicate with other shareholders about a corporation. Prior to these amendments, institutional investors who communicated with other investors about a company ran a serious risk of being deemed to have solicited a proxy, which would have required them to file a costly proxy statement.

Rule 14a-3 contains the central regulatory requirement of the proxy rules. No one may be solicited for a proxy unless they are, or have been, furnished with a proxy statement "containing the information specified in Schedule 14A." When the solicitation is made on behalf of the company itself (the "registrant") and relates to an annual meeting for the election of directors, it must include considerable information about the company, including related party transactions (see Schedule 14A, Item 6) and detailed information about the compensation of top managers (see Item D). When the proxy statement is filed by anyone other than management, it requires detailed disclosure of the identity of the soliciting parties, as well as their holdings and the financing of the campaign.

Rule 14a-3 raises the central question of what constitutes a "proxy" and a "solicitation." Rule 14a-1 provides sweeping definitions of these terms — a "proxy," for example, can be any solicitation or consent whatsoever. Rule 14a-2 provides important exemptions from these broad definitions. Rule 14a-2(b)(2) provides an exemption for solicitations to less than ten shareholders. Rule 14a-2(b)(1), added in 1992, provides an exemption for ordinary shareholders who wish to communicate with other shareholders but do not themselves intend to seek proxies. In addition, Rule 14a-1(l)(2)(iv) provides that announcements by shareholders on how they intend to vote, even if such announcements include the shareholders' reasoning, are not subject to the proxy rules. Of course, the SEC 1992 Release made clear that these exemptions did not exempt investors from Rule 14a-9 (discussed below), which prohibits false or misleading statements in connection with written or oral solicitations.[34]

Rules 14a-4 and 14a-5 regulate the form of the proxy — in effect, the actual "vote" itself — and the proxy statement, respectively. For example, the proxy must instruct shareholders that they can withhold support for a particular director on the solicitor's slate of candidates by crossing through her name (Rule 4(b)(2)(ii)). Similarly, subsection (d)(4) deals with circumstances under which a dissident can solicit votes for some but not all of management's candidates for the board (the so-called short-slate rule).

Rule 14a-6 lists formal filing requirements, not only for preliminary and definitive proxy materials but also for solicitation materials and Notices of Exempt Solicitations. Rule 14a-12 contains special rules applicable to contested directors — or, more specifically, solicitations opposing anyone else's (usually management's) candidates for the board. In particular, Rule 14a-12(a) permits dissident solicitations prior to the filing of a written proxy statement as long

34. Regulation of Communications Among Shareholders, Release No. 34-31326, 52 S.E.C. Docket 2028, Release No. IC-19031 (1992).

as dissidents disclose their identities and holdings, and do not furnish a proxy card to security holders. Finally, Rule 14a-12(b) deals with the treatment and filing of proxy solicitations made prior to the delivery of a proxy statement.

Rule 14a-7 sets forth the list-or-mail rule under which, upon request by a dissident shareholder, a company must either provide a shareholders' list or undertake to mail the dissident's proxy statement and solicitation materials to record holders (i.e., the intermediaries) in quantities sufficient to assure that all beneficial holders can receive copies.

PROBLEM: THE PROXY RULES MEET THE ACTIVE INSTITUTIONAL SHAREHOLDER

You are counsel to Midland Capital Management, a hedge fund whose investment premise is to make large investments in firms that can be improved, promote positive change, and if resisted, get on the board and do so from inside. If necessary Midland will try to acquire control, but its preferred technique is to be exposed through stock purchases and derivative to no more than 20 percent of a target firm's equity. Midland holds 1 percent of the outstanding shares of HLS, Inc. Since it has long been dissatisfied with HLS's lackluster management, Midland is considering a proxy campaign to elect three reputable business professors to HLS's nine-member board. Before initiating a campaign, however, Midland wishes to test the waters by circulating a memo outlining the prospective campaign to 15 other institutions that hold a total of 15 percent of HLS's outstanding stock. If its sister institutions respond favorably, Midland plans to file a proxy statement, distribute materials in support of its nominees to all HLS shareholders, and seek a public endorsement of its nominees from Institutional Shareholder Services (ISS), a shareholder rights group.

Advise Midland on the difficulties it may expect to confront. Is there a problem with nominating only three candidates? Who must file what, with whom, and when? At what points can the SEC intervene? Can Midland expect to incur any litigation costs? What access does Midland have under Rule 14a-7 to the HLS shareholder list? What access does it have under DGCL §219 or §220? Under which provision would you recommend it proceed?

Consider, in this regard, the proxy rules under Regulation 14A and Schedule 14A, in your statutory supplement. Look closely at the following rules in connection with the Midland's query: 14a-1(f) & (l); 14a-2(a)(6), (b)(1), & (b)(2), & (b)(3); 14a-3(a); 14a-6(a) to (c) & (g); 14a-7(a) & (e); 14a-9; and 14a-12(a) & (b). Please do *not* explore every clause of the proxy rules in thinking about this question.

Whether the proxy rules or other legal barriers impede collective action by shareholders depends not only on the rules themselves, but also on the identity of the shareholders. Large, passive institutions might well be deterred by the prospect of a lawsuit when scrappy value investors, hedge funds, like Midland or other activist shareholders are not. For an excellent analysis of the proxy rules from the perspective of the professional insurgent, see Thomas W. Briggs, *Shareholder Activism and Insurgency Under the New Proxy Rules*, 50 Bus. Law 99 (1994).

or whether the threat of them and their actions divert productive management. About this there is of course warm debate.[36]

6.9.3 Access to the Company's Proxy Statement: Rule 14a-8: Shareholder Proposals

Rule 14a-8 — the town meeting rule — entitles shareholders to include certain proposals in the company's proxy materials. From the perspective of a shareholder, this has the advantage of low costs: She can advance a proposal for vote by her fellow shareholders without filing with the SEC or mailing her own materials out to shareholders.

From the perspective of corporate management, Rule 14a-8 is at best a costly annoyance and at worst an infringement on management's autonomy. Management has a legitimate interest in excluding some materials from the proxy statement. The length of the proxy statement affects its intelligibility. Loyal agents would desire the proxy statement to be as concise as is consistent with effective communication of material matters and compliance with law. But management may also have other motives for excluding shareholder materials from the proxy statement. Management prefers to control the content of communications made by a corporation to its shareholders. Thus, access to the proxy statement is an important issue that, in the world of events, demands a great deal of attention from corporate counsel.

Regulation 14A provides a number of specific grounds to permit corporations to exclude shareholder-requested matter from the corporation's proxy solicitation materials. First, shareholder proposals must satisfy certain formal criteria: They must state the identity of the shareholder (Rule 14a-8(b)(1)), the number of proposals (Rule 14a-8(c)), the length of the supporting statement (Rule 14a-8(d)), and the subject matter of the proposal (Rule 14a-8(i)). Second, and more important, Rule 14a-8(i) lists 13 grounds that permit firms to exclude proposals from the company's solicitation materials. They include 14a-8(i)(1) — approval of the proposal would be improper under state law — and 8(i)(7) — the proposal relates to a matter of ordinary business. Matters of ordinary business, which you might suppose would be of interest to shareholders, are correctly regarded as the province of the board under the design of the corporate form.

Most Rule 14a-8 shareholder proposals fall into one of two categories: corporate governance or corporate social responsibility (CSR). Before 1985, 14a-8 proposals were mostly about CSR, which embraced topics ranging from environmental policies to personnel practices. Many such CSR proposals are still brought each year, although they rarely win more than 10 percent of the shareholder vote. During the 1990s almost up to the present, proposals dealing with corporate governance matters have dominated. Professors Randall

36. Compare, Bebchuk, Jiang & Brav, *The Long Term Effects of Hedge Fund Activism*, 115 Col. L. Rev. 1085 (2015) with, Allaire & Dauphin, *"Activist" Hedge Funds: Creators of Lasting Wealth? What Do the Empirical Studies Really Say?* (July 2014) http://www.wlrk.com/docs/IGOPP_Article_Template2014_Activism_EN_v6.pdf.

Thomas and James Cotter found that 72 percent of 14a-8 proposals submitted between 2002 and 2004 dealt with corporate governance issues.[37] These proposals addressed issues ranging from executive compensation (27 percent of the Thomas and Cotter sample) to "internal" corporate governance proposals such as the separation of the chairman and CEO roles (19 percent of the sample) to "external" corporate governance proposals such as dismantling poison pill or staggered board takeover defenses (23 percent of the sample). These proposals, which are often brought by labor unions or institutional investors, are now common and frequently win significant shareholder votes. In recent years CSR proposals again are growing as a percentage of all shareholder submission, apparently surpassing corporate governance topics in the 2015 proxy season.

Getting into the company's proxy can be a useful governance technique, even if it just to get a precatory vote on an issue. We noted above, for example, the stark decrease in staggered boards in S&P 500 companies (from more than 60 percent of all such firms in 2000 to approximately 25 percent in 2011), which appears to be almost entirely due to investor pressure. This is evidenced by frequent precatory shareholder votes made possible by getting into the company's proxy statement. Companies that wish to exclude a shareholder proposal generally seek SEC approval to do so. See Rule 14a-8(j). The SEC's approval of such a request is called a "no-action letter," since it takes the form of a letter stating that the SEC's Division of Corporate Finance will not recommend disciplinary action against the company if the proposal is omitted. The shareholder proponent has the opportunity to respond to the request for a no-action letter.

Corporate Governance Proposals. Most 14a-8 proposals are submitted by activists motivated to change social or governance practices. Hedge funds, on the other hand, are motivated by business concerns. Respecting governance the first group has been submitting proposals for years on such topics as separation of the board chair and CEO positions, compensation disclosure, redemption of poison pills, de-staggering of boards, election of directors by majority vote in uncontested elections rather than plurality, and access to the company's proxy to nominate directors. There are fewer governance proposals in recent years because for many companies most of these battles have been won by now.

We note in passing that the SEC has effectively encouraged shareholders to frame corporate governance resolutions in a precatory form — that is, as recommendations to the board of directors for adoption. Precatory resolutions sidestep questions concerning the scope of shareholder authority under state law. See the note following Rule 14a-8(i)(1). Since a large affirmative shareholder vote often has a dramatic effect even when a resolution is only precatory, shareholders may not have to give up much by adopting precatory language. Management may hesitate to offend a shareholder majority, even if its will is not binding.

37. Randall S. Thomas & James F. Cotter, *Shareholder Proposals Post-Enron: What's Changed, What's the Same?* (Table 2) (working paper Dec. 2005).

NOTE ON SHAREHOLDER PROXY ACCESS TO NOMINATE DIRECTORS

No issue in corporate governance has been so warmly contested and for so long as the question of under what circumstances, if any, should an investor have an ability to submit nominations for the board of directors into the company's proxy statement? Being able to put insurgent nominees into the company's own proxy materials would save some printing and mailing costs that were thought significant enough to be important. Management, on the other hand, has very warmly resisted this effort from the start, claiming that it would make the company's proxy confusing and would not be beneficial because boards function best collegially and when some nominees are proposed by "special interest investors" the quality of board function will be injured. We pass over an evaluation of these positions for the moment.

The issue of proxy access for shareholder nominations has a federal law aspect and a state corporation law aspect. During the period up to 2011 most of the effort to allow shareholders to gain access to the company's proxy to nominate directors was directed at the SEC in order to get a mandated rule that would govern all public companies. Since 2012, however, the effort to gain that access has been on a company-by-company basis largely governed by state law. Our treatment of this lengthy and complex issue is necessarily summary.

It was always possible under the corporation law for a charter or bylaw provision to mandate that the company provide access to its proxy to its shareholders under some set of conditions.[38] Such access was not generally available because (1) management did not favor it and thus did not suggest it and (2) shareholders were precluded by SEC regulations from gaining access to the company's proxy to place it up for vote. Thus, in a public company, no one could get the idea of such a bylaw up for a shareholder vote unless she wanted to bear the large cost of printing and distributing her own proxy solicitation materials. The point of the SEC prohibition was presumably to exclude shareholder nominees in the company proxy in order to avoid confusion. But in 2007, in response to a Second Circuit opinion that held that a proposed bylaw that would have provided limited shareholder access to the company's proxy in order to make a nomination, was not excludible under Rule 14a-8(i)(8) (as it then was),[39] the SEC amended that rule to say, in effect, "yes it is."

In 2010, however, the SEC reversed this position when it adopted Rule 14a-11, which mandated proxy access at all U.S. public companies for the purpose of shareholder nominations.[40] Under that rule, any shareholder or shareholder group that held more than 3 percent of a U.S. public company's shares for more than three years would be eligible to nominate candidates

38. In Delaware, this was confirmed in 2009 when, perhaps in an effort to preempt the issue, the legislature amended the DGCL to confirm that shareholders could amend the company's bylaws to permit proxy access. See DGCL § 112.

39. *AFSCME v. AIG*, 462 F.3d 121 (2d Cir. 2006.)

40. The rule was criticized as unnecessarily wooden in Fisch, *Destructive Ambiguity of Federal Proxy Access*, 61 Emory L. Rev. 436 (2012).

for up to 25 percent of the company's board seats. Rule 14a-11 never went into effect, however. It was voluntarily stayed by the SEC upon filing of a judicial challenge to the rule and was abandoned when the D.C. Circuit struck down Rule 14a-11 under the Administrative Procedure Act. In doing so the court accepted plaintiffs' argument that the SEC's process in considering and adopting the rule was insufficiently deliberate and rational. In April 2012, the SEC announced that it would not propose a new rule, but instead would now permit shareholders access to their company's proxy statement to propose proxy access bylaws on a company-by-company basis, thus belatedly adopting the Second Circuit's rule in *AFSCME v. AIG.*

So the battlefield now shifts to private ordering. Institutional investors — led by state pension funds and labor union pension funds — have waged a sustained effort to get individual companies to adopt proxy access bylaws under state law.

When a shareholder proposes a proxy access bylaw, the substantive issues will be principally four. First, the size of the shareholding that will qualify for access. Second, the length of continuous township required to qualify. Third, the number of shareholders that may join together to satisfy the share ownership requirement. And fourth, the maximum number of directors that may be nominated. There are other subsidiary issues, but these four structure the debate. The "market" has for the moment (2015) settled around a 3-percent, 3-year qualification for ownership (the SEC's standard in Rule 14a-11). The number of shareholders in the nominating group rarely exceeds 20 and the percentage of the positions open for election rarely exceeds 25 percent of the open seats.

Prior to the 2015 proxy season there were just 16 firms that went to vote on such amendments, with ten receiving majority support and six failing to do so. In 2015, proxy access emerged as a key issue, with the NYC Comptroller's "2015 Boardroom Accountability Project" seeking to install proxy access at 75 U.S. companies of diverse industries and market capitalizations. Several large pension funds supported the project (e.g., CalPERS) and similar efforts (e.g., TIAA-CREF). Multiple companies subsequently announced company-sponsored moves to provide proxy access voluntarily, with 3-percent/3-year threshold (e.g., GE, Citigroup, Yum Brands, Prudential Financial, Bank of America, Wendy's, Apache) or 5-percent/3-year thresholds (e.g., CF Industries, HCP, Priceline). Other companies resisted and recommended against a shareholder proposal: some prevailed (e.g., Apple, Coca-Cola, T-Mobile), while others did not.

Corporate Social Responsibility Proposals. There is a long tradition of socially motivated activism, designed to try to change corporate behavior in a way the proponent believes would be socially beneficial. Should shareholders have a federal right to place proposals in the corporation's proxy statement that are in opposition to lawful (but disapproved) activities of the firm? If so, under what circumstances? Generally, Regulation 14A permits management to exclude matters that fall within the ordinary business of the corporation (Rule 14a-8 (i)(7)). Suppose, for example, that the corporation decides to buy from the cheapest available source, a foreign supplier. Assume that this source is suspected of using prison labor and that a shareholder group believes this is immoral and bad business. (They argue the corporation will suffer long-term reputational damage.) Can these shareholders include a precatory resolution in the company's proxy demanding that it cease doing business with the foreign source under Regulation 14A?

The SEC has waffled on social responsibility proposals. In 1991, it strayed from its earlier policy, under which the (then current) Rule 14a-8(c)(7) required issuers to include proposals that related to "matters which have significant policy, economic or other implications in them." In its 1991 no-action letter to the Cracker Barrel Old Country Store, Inc., the SEC agreed that Cracker Barrel could omit a shareholder proposal calling on the board to prohibit employment discrimination based on sexual orientation. The SEC asserted that it could not easily determine which employment-related matters fell within the "ordinary business exclusion" and would therefore permit the exclusion of all such proposals.

However, in July 1997, the SEC waffled back, proposing changes to Rule 14a-8, including a reversal of its *Cracker Barrel* policy and a return to its previous interpretation of the "ordinary business" exclusion with respect to a company's personnel policies. Consider the SEC's explanation.

The Interpretation of Rule 14A-8(c)(7): The "Ordinary Business" Exclusion

When adopted in 1953, the "ordinary business" exclusion had a fairly straightforward mission: to "relieve the management of the necessity of including in its proxy material security holder proposals which relate to matters falling within the province of management."

That mission became more complicated with the emergence of proposals focusing on social policy issues beginning in the late 1960s. As drafted, the rule provided no guidance on how to analyze proposals relating simultaneously to both an "ordinary business" matter and a significant social policy issue.

In 1976, the Commission considered revisions to the "ordinary business" exclusion, hoping to fashion more workable language distinguishing between "mundane" business matters and "important" ones. It declined to adopt the new language after commentators expressed concern that the new language might be overly restrictive and difficult to apply. In lieu of adopting revisions, the Commission stated that it would apply the exclusion in a "somewhat more flexible manner."

In applying the "ordinary business" exclusion to proposals relating to social policy issues, the Division applies the most well-reasoned standards possible, given the complexity of the task. From time to time, in light of experience dealing with proposals in particular subject areas, it adjusts its approach. Over the years, for instance, the Division has in several instances reversed its position on the excludability of proposals involving plant closings, the manufacture of tobacco products, executive compensation, and golden parachutes.

Another of these interpretive adjustments is a subject of today's proposals. In a 1992 no-action letter issued to the Cracker Barrel Old Country Stores, Inc., the Division announced that the fact that a shareholder proposal concerning a company's employment policies and practices for the general workforce is tied to a social issue will no longer be viewed as removing the proposal from the realm of ordinary business operations of the registrant. Rather, determinations with respect to any such proposals are properly governed by the employment-based nature of the proposal. . . .

The *Cracker Barrel* interpretation has been controversial since it was announced.[71] While the reasons for adopting the *Cracker Barrel* interpretation continue to have some validity, as well as significant support in the corporate community,[72] we believe that reversal of the position is warranted in light of the broader package of reforms proposed today. Reversal will require companies to include proposals in their proxy materials that some shareholders believe are important to companies and fellow shareholders. . . . That is, employment-related proposals focusing on significant social policy issues could not automatically be excluded under the "ordinary business" exclusion.

Under this proposal, the "bright line" approach for employment-related proposals established by the *Cracker Barrel* position would be replaced by the case-by-case analysis that prevailed previously. Return to a case-by-case approach should redress the concerns of shareholders interested in submitting for a vote by fellow shareholders employment-related proposals raising significant social issues. . . .

Despite return to a case-by-case, analytical approach, some types of proposals raising social policy issues may continue to raise difficult interpretive questions. For instance, reversal of the *Cracker Barrel* position would not automatically result in the inclusion of proposals focusing on wage and other issues for companies' operations in the Maquiladora region of Mexico, or on "workplace practices."

Finally, we believe that it would be useful to summarize the principal considerations in the Division's application of the "ordinary business" exclusion. These considerations would continue to impact our reasoning even if the proposals are adopted. The general underlying policy of this exclusion is consistent with the policy of most state corporate laws: to confine the resolution of ordinary business problems to management and the board of directors since it is impracticable for shareholders to decide how to solve such problems. . . .

The policy underlying the rule includes two central considerations. The first relates to the subject matter of the proposal. Certain tasks are so fundamental to management's ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight. Examples include the management of the workforce, such as the hiring, promotion and termination of employees, decisions on production quality and quantity, and the retention of suppliers. However, proposals relating to such matters but focusing on significant social policy issues generally would not be considered to be excludable, because such issues typically fall outside the scope of management's prerogative.

The second consideration relates to the degree to which the proposal seeks to "micro manage" the company by probing too deeply into "matters of a

71. Shortly after its announcement, the New York City Employees Retirement System unsuccessfully challenged the Commission's authority to adopt the position. See *New York City Employees' Retirement System v. SEC*, 843 F. Supp. 858, *rev'd* 45 F.3d 7 (2d Cir. 1995). The Amalgamated Clothing and Textiles Union successfully challenged Wal-Mart's decision to exclude an affirmative action proposal after the Division concurred that the proposal could be excluded. See *Amalgamated Clothing and Textile Workers Union v. Wal-Mart Stores, Inc.*, 821 F. Supp. 877 (S.D.N.Y. 1993). During the last proxy season, we declined proponents' requests that we review three Division no-action responses implicating the interpretation, and concerning companies' affirmative action policies and practices. Commissioner Wallman dissented, and issued a dissenting statement.

72. In response to the Questionnaire, 91% of companies favored excluding employment-related shareholder proposals raising significant social policy issues under the *Cracker Barrel* interpretation. 86% percent of shareholders thought such proposals should be included.

complex nature that shareholders, as a group, would not be qualified to make an informed judgment on, due to their lack of business expertise and lack of intimate knowledge of the (company's) business." This consideration may come into play in a number of circumstances, such as where the proposal seeks intricate detail, or seeks to impose specific time-frames or methods for implementing complex policies. . . .

In 1998, the SEC adopted the proposed amendments described above and withdrew the *Cracker Barrel* no-action letter. Thus, the commission returned to a "case-by-case analytic" for determining whether issues relating to employment practices were excludable as ordinary business matters or whether they were sufficiently important to the company to be an appropriate subject of a Rule 14a-8 resolution. See SEC Release No. 34-40018, Fed. Sec. L. Rep. (CCH) ¶86,018.

As the 1998 release notes, a 14a-8 proposal must focus on "significant social policy issues" and must not seek to micromanage the business in order to avoid running afoul of the ordinary business exclusion. As you might expect, the contours of this line have been murky. For example, in October 2007, as part of a larger campaign to combat discrimination based on sexual orientation, the New York City Employees' Retirement System (NYCERS) submitted a 14a-8 proposal to Apache Corp. requesting that Apache implement a program based on ten "equality principles." Apache sought a no-action letter from the SEC under the (c)(7) exclusion, arguing that the proposal related to ordinary business matters. In March 2008, the SEC accepted this argument and issued a no-action letter stating that Apache could exclude the NYCERS proposal. NYCERS challenged the SEC's decision in federal district court. Despite evidence that the SEC had denied no-action relief for similar proposals in the past, the district court endorsed the SEC's no-action letter for Apache.[41]

Today, corporate social responsibility is a major concern for companies and boards. A record 458 "environmental and social" Rule 14a-8 shareholder proposals were submitted during the 2014 proxy season (overtaking governance proposals in number). As of mid-March 2015, there were 447 E&S proposals, including: political contributions, lobbying activity and other political issues (113); environment/climate change (110) and sustainability (29); human rights (36); and board of director diversity (24) and EEO/sexual orientation (17).

6.9.4 Rule 14a-9: The Antifraud Rule

As we will see in later chapters, private suits by investors alleging injury as a result of a violation of the federal securities laws have, over the last forty years, emerged as an important device for enforcing these laws. Congress did not create most of the provisions of private rights of action that are important today. Only the SEC is expressly authorized to enforce the securities acts and

41. *Apache Corp. v. New York City Employees' Ret. Sys.*, No. H-08-1064, 2008 WL 1821728 at *5 (S.D.Tex.Apr. 22, 2008).