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.[47] 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 in Chapter 13, 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

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. 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.

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

47. 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.

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 they must be given,[48] and how they can 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, in 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 delegated decision making[49] 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

48. 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.

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

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 on 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 is a "republic," 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. CUNINGHAME

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 three-quarters of the shareholders). 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.]

COLLINS, M.R.

. . . 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 the right of the shareholders meeting to remove directors is weaker in the U.S. than in many jurisdictions, including the U.K. and most of continental Europe.[50] Under most company law statutes, the general

50. The primary exception is Germany, where the codetermination law allocates half of the board seats in large companies to employee representatives rather than shareholders. In the case of an evenly divided board, however, the chair — a shareholder representative — casts a second and decisive vote. See Luca Enriques et al., in The Basic Governance Structure: The Interests of Shareholders, in Kraakman et al., eds., *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 3rd ed. (2017).

shareholder meeting is explicitly recognized as the "highest managerial organ," able to countermand the board on any decision.[51] Might this difference be explained by the tendency of U.S. public companies to be widely held while their European counterparts tend toward concentrated ownership?

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 are advisory, they may include nondirectors; should they exercise any part of the board's power, they must be composed entirely of directors. Under general practice (and New York Stock Exchange listing requirements), board committees include special committees on audit, nominations, and

51. See John Armour et al., What is Corporate Law?, in *The Anatomy*, *supra*.

6

NORMAL GOVERNANCE: THE VOTING SYSTEM

6.1 Introduction: Shareholder Voting in the New Corporate Governance

The corporate form derives much of its utility by according broad discretion to a centralized management structure. Of course, there are some limits to the discretion of corporate boards, including those imposed by the fiduciary duties of directors. And corporate charters can tie the hands of directors (and controlling shareholders) in many ways, as in fact they often do in closely held companies. But remarkably few public companies restrict board discretion in their charters. Instead, dispersed shareholders in public corporations largely rely on three powers to counter overreaching by corporate boards. Professor Robert Clark has aptly summarized these powers as the right to vote, the right to sell, and the right to sue. This Chapter focuses on shareholder voting rights in the selection of directors and in the approval of resolutions sponsored by either the board or by shareholders. And, as between these sorts of voting rights, we emphasize the shareholder's right to elect the members of the board of directors. Subsequent Chapters examine the right to vote on fundamental transactions in more detail, as well as the rights to sue and sell.

Understanding the role of shareholder voting in corporate governance requires a review of the legal machinery that constitutes what might be described as part of the "normal governance" of the corporation. This includes shareholder meetings, procedures for electing and removing directors, proxy voting, shareholder information rights, and judicial superintendence of shareholder voting. We also touch on the SEC's proxy rules that govern mandatory disclosure and proxy voting in public companies, with particular attention to a shareholder's right to bring resolutions concerning corporate governance and social responsibility to a vote at annual shareholders meetings. But before addressing these topics, we introduce two considerations that are broadly relevant to the governance of publicly traded companies: the distribution of share ownership and the rise of institutional investing.

6.1.1 Ownership Structure and the Collective Action Problem

All else being equal, the importance of shareholder voting in corporate governance is tied to ownership structure; that is, to how shares are distributed among shareholders. This is easy to see at the two extremes of a continuum of the possible distributions of voting rights — firms with controlling shareholders and those held by widely-dispersed small shareholders. In companies with controlling shareholders, a single shareholder or group of shareholders might control sufficient votes to appoint the entire board of directors unilaterally. In this case the votes of minority shareholders simply do not matter to the composition of the board (although they matter to shareholder votes on other critical matters such as fundamental corporate transactions).[1]

Controlling or dominant shareholders are more common than is generally appreciated, but most large U.S. companies have, to one degree or another, a more dispersed shareholder base. The polar opposite of the controlled company is thus at least as important for understanding the limits of shareholder voting, and it is at this extreme that the shareholders' collective action problem is most severe. A stylized hypothetical makes the point. Assume that a widely held corporation has 100,000 shareholders, each of whom holds \$100 of its stock. Suppose also that this corporation has performed badly for a decade and that its directors, whose average tenure is 25 years, show no signs of responding to their company's slow decline. The question is whether the company's many small investors can replace the incumbent board with new directors committed to change, which might mean anything from devising a new business plan to auctioning off the company to the highest bidder. The answer is probably not, at least not without outside intervention and perhaps not even with it.[2]

If the company's many small shareholders are rational, none of them will individually undertake to recruit new board candidates and solicit other shareholders to support them at the next shareholders meeting (triggering what is termed a "proxy contest"). Leading such a campaign against incumbent directors would be far more costly than the pro rata benefit a small shareholder might receive from saving the company. Even a doubling of firm value only benefits an individual shareholder by \$100, which is far less than the costs in time and resources of running a proxy campaign.

But might a large outside investor intervene, say, by buying 10 percent of the company's stock before undertaking a proxy contest? Maybe, because

1. Majority-of-minority shareholder votes, sometimes termed "MOM" votes, may affect the standard of review that courts employ when passing on fundamental transactions sponsored by controlling shareholders with conflicted interests. More on this in Chapters 8, 11, and 13. Controlling shareholders routinely appoint financially independent directors to the boards of their companies, in part to deflect charges that they favor their private interests over those of minority shareholders.

2. You might respond that shareholders can jump off the train by selling their shares. But consider that if the market is well informed about the company's trajectory, the price at which they can sell their shares will fully reflect their company's dismal prospects.

such an investor has a greater incentive to gather information and act on it, in contrast to the small shareholders who have little incentive to inform themselves beyond occasionally glancing at share prices. And even if a concerted effort left small investors favorably disposed toward the insurgent side in a proxy contest, it might not be enough to attract their votes. They might reasonably believe that their individual votes won't matter to the outcome of the contest and skip the bother of voting at all. The lesson here is that shareholder voting matters most where there is no controlling shareholder *and* where some shareholders hold stakes large enough to initiate a proxy contest if they think their company is struggling. However, even here generating informed shareholder action is not easy.

Throughout much of the twentieth century, share ownership has seemed too dispersed to support collective shareholder governance via voting. The dominant view of public corporations has tracked the analysis developed by Adolf Berle and Gardiner Means in their seminal 1932 study of the American corporation.[3] These authors confirmed what must have already been obvious in their day, that dispersed small shareholders are largely irrelevant to corporate governance. But they took this observation to the next level by examining the inheritors of control after many controlling shareholders left the scene — namely a rising class of expert and seemingly autonomous managers. This class, they argued, was a novel development in the evolution of the business enterprise because it marked a radical "separation of ownership and control."[4] In the decades after Berle and Means' monograph, most commenters came to accept their description of the large American corporation, even though they differed widely over its policy implications. The focus on retail investors affected securities regulation as well. A popular view after the passage of the Securities Exchange Act of 1934 was that the federal agency created to regulate the securities markets, the Securities and Exchange Commission (SEC), should exercise its powers to protect small shareholders from manipulation by large shareholders, even if a casual reading of Berle and Means might have suggested otherwise, namely that incumbent managers — not small shareholders — were the most likely beneficiaries of policies that discouraged collective action among larger shareholders. Indeed, prior to a significant reform of the SEC's proxy rules in 1992, a strong case could be made that SEC regulations worked to diminish the franchise of all shareholders, small and large.[5]

During the 1980s and 1990s, influential commentators offered other views on the collective action problem of disaggregated public shareholders. Two perspectives that emerged in the law-and-economics and finance literatures argued that market developments already compensate for some organizational disabilities inherent in diffuse shareholder ownership. One argued that corporate governance concerns are — or can be — answered in significant part by competitive markets in products, capital, managerial expertise,

3. Adolf Berle & Gardiner Means, *The Modern Corporation and Private Property* (1932).
4. *Id.* at 5.
5. See John Pound, *Proxy Voting and the SEC*, 29 J. Fin. Econ. 241 (1991).

and corporate control.[6] A second account points to the growing importance of concentrated private ownership in the form of private equity and venture capital in many sectors of the economy.[7] But the literature most salient for this Chapter addressed the implications of pervasive institutional ownership for the governance of publicly-traded corporations.

6.1.2 Institutional Investors and Shareholder Voting

As of 2019, institutions held about 80 percent of the shares in public companies listed in the Russell 3000, a broad-gauge index of public corporations.[8] Since the 1980s, institutional ownership has been recognized as a potential game-changer for shareholder participation in corporate governance.[9] Expectations grew after large state pension funds successfully lobbied for an overhaul of the SEC's proxy rules. After the 1992 reforms, shareholders could more freely share their views with more than a handful of their peers about pending corporate issues and publicly disclose how they would vote in shareholders meetings. No one in the 1960s or 1970s could have foreseen that institutional investors would pressure boards during the 1990s to fire CEOs at leading firms such as General Motors, IBM, Sears, Westinghouse, and American Express. Nor could they have anticipated the reforms in statutory law and governance practice that followed after the 1990s. Among the open questions today are the limits on institutional engagement in the governance of individual companies, the values that institutions champion and, of course, the costs and benefits of their interventions.

The gross statistics on institutional ownership of U.S. public companies and the sheer size of asset managers such as BlackRock, Vanguard, State Street, and Fidelity suggest a re-concentration of voting power in public corporations. This reduces the shareholders' collective action problem and might, in some measure, reverse the separation of ownership and control identified by Berle and Means. But of course, the world of institutional investing is not so simple. The institutional owners of shares — the mutual funds, pension funds, bank trust departments, insurance companies, and endowments — have different objectives and face different incentives. And many of these owners contract out the management of their assets and voting rights to investment advisors, which introduces yet another layer of agency relationships and costs. For example, asset managers are generally compensated in proportion to the size of the assets under management rather than by increases in the value of the portfolios they manage. There are also other important differences that undercut the alignment of interests between institutional owners

6. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (1991).

7. See, e.g., Michael C. Jensen, *Eclipse of the Public Corporation*, Harv. Bus. Rev. (Sept.-Oct. 1989).

8. See Charles McGrath, *80% of Equity Market Cap Held by Institutions*, Pensions & Investments, April 25, 2017.

9. See, e.g., Bernard Black, *Agents Watching Agents, The Promise of Institutional Investor Voice*, 39 UCLA L. Rev. 811 (1991).

and fund managers. Thus, how managers will engage in the affairs of portfolio companies by voting or otherwise is by no means clear.

We touch on the world of institutional investing again in Section 6.8. But it may be helpful to keep this world and the collective action problem in mind while reviewing the legal structure of shareholder voting rights.

6.2 Electing and Removing Directors

6.2.1 Electing Directors

Corporate law requires that every corporation have at least one class of voting stock to elect its board of directors. Moreover, every corporation must have a board of directors, even if this "board" has only a single member. DGCL §141(a). Unless the corporate charter provides otherwise, the statutory default is that each share of stock has one vote — no more, no less. DGCL §212(a). However, since the charter can provide otherwise, the legal mandate that there be *some* voting stock is by itself a trivial constraint on governance design. Public corporations usually stick to the plain vanilla default of issuing a single class of voting common stock, although an important exception — that we will address shortly — is companies that issue a class of low-vote common stock but whose founders or other insiders retain a lock on control by holding second or third classes of common stock with multiple voting rights.

So-called "dual-class" common stock is the exception that proves the rule. But it also raises another question: Why Is voting stock mostly common stock rather than preferred stock or a hybrid security that mimics the features of corporate debt? (Warning: There are also important exceptions to this rule of thumb.[10]) One explanation is that common shareholders value voting rights more than other investors. Common shares have no maturity date and no legal right to periodic payments. By contrast, 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. Likewise, preferred shareholders enjoy contractual protections such as liquidation preferences and prior claims on corporate dividends. Put differently, the right to appoint corporate directors is the only protection that common stockholders have. Even if these stockholders are too dispersed to influence the boards they elect, they have the comfort of knowing that control of the board will not fall into the hands of other classes of investors and stakeholders whose interests are inimical to their own.[11] But if, more optimistically, common stock can command the allegiance of the board, there may be yet another reason to award it exclusive voting rights.

10. Among these exceptions is venture capital ("VC") financing, where VC funds conventionally take convertible preferred stock with voting rights while entrepreneurs retain voting common stock.

11. For a classic analysis of the apportionment of control rights among different enterprise constituencies, see Henry Hansmann, *The Ownership of Enterprise* (1996).

As residual claimants, common stockholders have stronger incentives than other constituencies to increase the value of the corporate enterprise as a whole. Of course, this observation rests on other assumptions as well — that common shareholders agree on maximizing long-term firm value as their common objective, and they also agree on the policies or managers that can best advance this objective.

Another mandatory feature of the voting system is the *annual* election of directors.[12] 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 shareholders meeting, elected directors must meet the affirmative vote requirements provided in their company's bylaws or charter or, if these are not provided, elected directors need only receive a plurality of votes at the shareholders meeting as long as Delaware's easy quorum requirements are satisfied. DGCL §216. Thus, Delaware's statutory default sets a low threshold for election. Under the plurality default, 5 percent of the shares present at the meeting can elect a director, even if 95 percent of the shares present withhold their votes. Should such embarrassing discrepancies arise, however, one form of redress available to Delaware shareholders is to amend their company's bylaws to require that a nominee's election requires an affirmative vote of a majority of the votes of the shareholders present. The Delaware statute bars boards of directors from amending or repealing a stockholder-adopted bylaw that fixes vote requirements. Thus, a shareholder resolution suffices to implement a majority vote requirement. This may be one reason why the boards of most large public companies have implemented a majority-of-votes-cast election rule on their own initiative.[13] Another reason might be the uncomfortable optics of opposing majority elections.

Corporate law facilitates the election of directors by creating a flexible framework for holding the annual meeting of shareholders. Generally, 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 statute, a corporation's actual notice period, quorum requirement, and record

12. 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.

13. 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.

date will be established in the charter or in a bylaw or, in the case of record date and notice, by the board in the manner authorized by those documents.

CUMULATIVE VOTING

The default voting regime provides 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 left without 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 being seated on the board.

To see how cumulative voting works, 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 state legislatures and certain shareholders a century ago, it was never popular with managers who preferred collegial boards able to reach unanimous decisions without deadlock or untoward dissent. Boards with divided shareholder allegiances were said to be too adversarial. Thus, few companies have adopted cumulative voting during the last fifty years.[14] Where a corporate charter does mandate cumulative voting, however, it affects the exercise of the shareholders' rights to remove directors (since it 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).

6.2.2 Removing Directors

State corporate law provides for the right to remove directors, which is no less important than the right to elect them. Under the DGCL,

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

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 written consent, as explained below.

When a board is staggered (DGCL §141(d)), removal is difficult. The leading case, *Campbell v. Loew's Inc.*,[15] establishes that a director is entitled to certain due process rights before he or she can be removed for cause. Just what these rights are remains unclear, as does the meaning of "good cause." Certainly, fraud or unfair self-dealing give 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 the predicate of the "cause" requirement, then poor business judgment alone would not be cause for removal. See DGCL §141(k), which confers broad removal power on shareholders.

Most corporate statutes, including the DGCL, bar directors from removing fellow directors, for cause or otherwise, without 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, permit shareholders to grant the board power to remove individual directors for cause. See, e.g., NYBCL §706. In all events, a board uncovering cause for removal can petition a court of competent jurisdiction to remove the director in question from office. It is generally conceded that any court of equity supervising the performance of any fiduciary has an inherent power to remove for cause.[16]

PROBLEM: THE UNFIREABLE CEO

Village, Inc., is a Delaware corporation that provides online fashion advice and individualized consulting services to law students and young lawyers. The firm had its initial public offering (IPO) two years ago, but after a meteoric rise, its stock has fallen steadily for the past 18 months. Wildman West, who is Village's CEO, owns 25 percent of its single class of common stock. The balance of its stock is widely held. Since West is the only large blockholder of Village shares, he has appointed all of its directors since its IPO. Over the past year, however, the word on the street has been that Village's sagging share price could make it a possible target for a takeover attempt. West and his directors responded to these alarming rumors by amending Village's bylaws to mandate a nine-member board divided into three classes, of which only one class is subject to a shareholder vote annually (a classified or staggered board). In addition, West's board solicited and received shareholder approval to amend the Company's charter to (1) vest exclusive power

15. 134 A.2d 852 (Del. Ch. 1957).

16. Ordinarily, only the courts of a corporation's home state can remove one of its directors because the law of a company's legal domicile governs its internal affairs. However, federal courts may exercise this authority as well when a corporation is publicly traded, and therefore registered under the Securities Exchange Act of 1934.

their company's business plan and sufficiently committed to the composition of the board. In all events, as with many issues of corporate law, we can easily state a general principle such as "maximize the value of the firm," but find that it is difficult to apply it without controversy. Either encouraging special meetings (and accepting the costs) or discouraging them (and allowing directors freer rein) may increase or decrease the value of a firm.

Putting the matter of meetings in the corporate charter allows corporate planners to decide for themselves in particular cases. The Model Business Corporation Act (MBCA, 2016 Revision) offers a typical solution. Under §7.02, a corporation must hold a special meeting of shareholders if (1) such a meeting is called by the board of directors or a person authorized in the charter or bylaws to do so, or (2) 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).

6.3.2 Shareholder Consent Solicitations

Shareholders often 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 MBCA, for example, requires unanimous shareholder consent. See MBCA §7.04(a).

6.4 Proxy Voting and Its Costs

Shareholder meetings require a quorum to act. Dispersed share ownership ensures that most shareholders of public companies will not physically attend shareholder meetings. To meet quorum requirements and provide a semblance of collective decision making, the boards and officers of these companies collect proxies — essentially agency agreements — that authorize agents at these meetings to vote in accordance with the shareholder's instructions. It is important to note, however, that the standard proxies distributed to the shareholders of public corporations today differ from the conventional ballots that voters receive in political elections in one key respect. Modern proxies allow shareholders to vote in favor of the board nominees proposed by the party distributing its proxy cards or to withhold their vote from some or all of this party's nominees, but they do not allow shareholders to vote another party's candidates on the same proxy card. The "political" convention allows voters to mix and match candidates from contesting parties on a single ballot. Such ballots are not unknown in the corporate context where they are termed "universal proxies," but they are exceedingly rare for both legal and institutional reasons. One must also consider that the vast majority of corporate elections are uncontested and the board's proxy card is the only one that shareholders receive. In these "normal" shareholder meetings, there is no difference between a conventional proxy and a universal proxy.

State law does not prescribe a particular form for corporate proxies any more than it regulates agency agreements in other contexts. Under state law, all that is required for a valid proxy is that a shareholder designate the proxy holder and authenticate the grant of the proxy. The proxy holder, in turn, is bound to exercise the proxy as directed. Proxies usually include a list of the specific nominees and specific issues on which the proxy holder proposes to vote. But proxy holders are generally free to exercise independent judgment on issues arising at the shareholder meeting for which they have not received specific instruction. Although the traditional form of a corporate proxy was and still is a signed "proxy card," modern statutes 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).[23]

But if state law is relaxed about the form that corporate proxies may take and the ways in which they may be solicited, federal securities law regulates a great deal about the solicitation and use of proxies in publicly traded firms. As we mentioned above, federal regulation centers on Section 14(a) of the Securities Exchange Act of 1934, which vests the SEC with the authority to promulgate its highly prescriptive Proxy Rules and supports an extensive body of case law in the federal courts that addresses all aspects of proxy regulation, but most particularly the regime of mandatory disclosure under Section 14(a) and the broad scope of its antifraud provision. We return to these topics in Section 6.9 below.

A significant consideration bearing on shareholder voting is the expense of mounting a proxy contest in a publicly traded company. This is yet another example of the familiar collective action problem. One measure of independent shareholder participation in corporate governance might be the ease

23. See also the "Eproxy rules," SEC Rule 14a-16, requiring all public companies to post their proxy materials on a publicly available website and requiring a mail "Notice of Internet Availability of Proxy Materials." The rule adopted in 2007 has not yet revolutionized practice. See Rachel Geoffroy, *Electronic Proxy Statement Dissemination and Shareholder Monitoring* (November 30, 2018). Available at SSRN: https://ssrn.com/abstract=3264846.

When shareholders grant two conflicting proxies, the more recent one automatically revokes its predecessor unless the first proxy was given to protect an important interest of the recipient rather than merely to instruct an agent about a shareholder's voting preferences. 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).

with which proxy voting allows them to challenge incumbent directors at shareholder meetings. And here the obvious constraint on shareholder choice is that they cannot displace incumbent directors unless they can vote for a credible slate of competing nominees. This means, in turn, that disaggregated shareholders can directly influence the composition of corporate boards only if some person or organization undertakes the considerable expense of running a campaign. This entails recruiting insurgent board candidates, soliciting the support of influential shareholders, making the insurgent case to other shareholders and the press, and retaining a team of professionals — lawyers, proxy solicitors, and PR consultants — whose services are essential for success. Of course, no one initiates a proxy contest solely because it would benefit shareholders as a class. The insurgents who launch a proxy campaign must expect a private benefit commensurate with the costs they incur. Little wonder, then, that contested corporate elections are uncommon and that shareholders can express dissatisfaction with their board only in more oblique ways, such as refusing to vote for some or all of management's nominees (so called "withholding" their votes).

But is the absence of effective shareholder choice in 99 percent of corporate elections a bug or a feature? From the management's perspective, too many proxy contests might seem to be a nightmare. They would threaten to destabilize firm leadership, disrupt long-term business planning, and open the boardroom to the candidates of poorly informed shareholder factions and conflicting agendas. Corporate law must address these concerns as well. In "normal" or uncontested corporate elections, the corporate treasury pays the bills for soliciting proxies on behalf of the board's nominees. It could hardly be otherwise. Each year, public corporations prepare proxy statements that disclose their financial statements, management's discussion of the state of the business, and much more including the board's candidates for election at the annual shareholders meeting. A proxy statement on file with the SEC allows a company to solicit shareholder proxies to ensure that it will have a quorum at the shareholders meeting and acceptable shareholder support for its incoming board.[24] Financing the proxy statement and soliciting shareholder approval is a normal business expense that the company pays for as a matter of course. But should the same rules apply if the company incurs extraordinary expenses to defend the incumbent board in a proxy fight? Expensive proxy contests in S&P 500 companies can cost north of $50 million, while the typical contest in smaller public companies seems and lie between $750,000 and $2 million.[25]

Champions of shareholder rights might point out that the standard practice of funding management's side in proxy contests handicaps insurgents and

24. DGCL §216 provides a quorum requirement of "a majority of shares entitled to vote, present in person or represented by proxy." Note that if the meeting has only non-routine matters on which to vote (e.g., a merger), then a broker cannot vote the shares of the beneficial owner without instructions from the owner (NYSE Rule 452). These broker non-votes are not counted toward quorum. See Douglas K. Schnell & Angela Chen, *Counting Shareholder Votes*, 33 Insights 3 (May 2019), available at: https://www.wsgr.com/publications/PDFSearch/insights-2019-05-31.pdf.

25. See Investment Company Institute, *Analysts of Fund Proxy Campaigns: 2012-2019* (Dec. 2019), available at: https://www.sec.gov/comments/4-725/4725-6580709-201124.pdf; Mike Coronato, *2017 Proxy Fights: High Cost, Low Volume*, FactSet (Nov. 6, 2017), https://insight.factset.com/2017-proxy-fights-high-cost-low-volume).

favors incumbent control. If these critics are right, there are too few proxy contests rather than too many. Still, what can be done to mitigate incumbent bias? Any proposal to scale back corporate support for incumbent boards seems like a non-starter. No one expects directors to pay personally to defend policies that they believe to be in the corporation's best interests. Perhaps an alternative, then, is to require corporations to reimburse insurgents partially for their reasonable expenses. From one perspective, this might seem absurd. Why should corporations defend incumbent boards to the end, and also fund their opponents, thereby increasing the costs of defending the board? But from an institutional perspective, reimbursing insurgents might seem plausible if proxy contests are thought to benefit all shareholders by challenging poorly performing managers. Chapter 10 addresses an analogous paradox that arises in the context of shareholder lawsuits. To demonstrate that this is a live question in the context of proxy voting, we need only cite DGCL §113, which authorizes shareholders or boards to enact a bylaw providing for the partial reimbursement of the costs of a losing insurgent campaign in certain circumstances. We do not know how many companies actually have a §113 bylaw provision.

The problem below and the leading case that follows it explore the majority common law position on the reimbursement of proxy solicitation expenses. We suggest reading the problem first and the case next, and then returning to the problem and the commentary that follows the case.

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 its solicitation costs.

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)

FROESSEL, 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 continue to invest in issues of low-vote shares despite their distaste. Moreover, it is unclear whether they suffer losses from them on average. The risk of future agency costs is clear when dual-class firms go public. Under standard assumptions, these costs should be priced into the stock's offering price. If the founders of successful start-ups willingly accept discounts on the shares they sell to indulge their personal taste for control, why not let them? Otherwise they might not take their companies public at all. Another view is more enthusiastic. It claims that dual-class voting structures at the IPO stage affirmatively increase the value of some companies in the eyes of shareholders. The conjecture is that dual-class voting serves to retain, not entrench, dedicated and visionary entrepreneurs who might otherwise be displaced by activist shareholders intent on short-term gains.[41]

The empirical literature on whether low-vote IPOs diminish or increase shareholder returns is inconclusive. Instead, policy debates over these IPOs address modest reforms. If the principal concern is that even visionary entrepreneurs grow stale over time, then an obvious fix is a sunset provision that converts high-vote shares into ordinary common stock at the end of a fixed period, or even better, puts the continuation of the dual-class structure to an up or down vote by the low-vote shares.[42] Other possible reforms seek to limit the extent to which high-vote shareholders can reduce their economic ownership of the company, transfer their shares to their heirs, or even sell them to third parties. Current dual-class regimes generally provide that high-vote shares lose their special voting rights upon transfer but are less likely to feature sunsetting clauses. As always, the devil is in the details.

QUESTION

What is the functional difference between a firm issuing both a class of "no-vote" shares and a class with 10 votes per share versus a firm issuing a class of one-vote shares and a class with 10 votes per share? Are there reasons to prefer the issuance of no-vote shares in this example?

6.8 VOTING IN TODAY'S CORPORATION

As the introduction to this chapter noted, institutional owners and asset managers now vote most shares in U.S. public corporations. The big asset managers such as BlackRock, Vanguard, Fidelity, and State Street offer their clients

41. For a related argument in the context of publicly traded firms, see Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 Yale L. J. 560 (2016).

42. See Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 Va. L. Rev. 585 (2017); Robert J. Jackson, Jr., *Perpetual Dual Class Stock: The Case Against Corporate Royalty* (Feb. 15, 2018). See also Jill E. Fisch & Steven Davidoff Solomon, *The Problem of Sunsets* 99 B.U. Law Rev. 1057 (2019); Scott & Gulliver, *supra* note 40, at 28-30.

a variety of funds in which to invest that are usefully divided into passive and active. Passive funds track various indices such as the S&P 500, while active funds allow their managers to add and remove portfolio companies in an effort to beat the market. While the managers of both kinds of funds earn fees based on their total assets under management, active funds recruit new investors by increasing the value of their portfolios relative to the market in general. It may be, in fact, that the managers of active funds follow individual companies more closely across the broad range of all service providers. Curiously, however, in the important case of giant fund families, such as BlackRock, the voting of managed shares seems to be coordinated at the family level rather than at the level of individual funds, whether they are active or passive, and presumably reflect the blended interests of all family funds.[43]

In total, a handful of the largest fund families are thought to control over $20 trillion in passive or indexed assets, which represents about 25 percent of the stock in U.S. publicly traded firms by recent estimates.[44] Thus, the voting incentives of these fund families is no small matter, even though they also include a smaller proportion of actively-managed firms. On its face, it would seem that passive fund managers should have no interest in the performance of individual portfolio companies. Were they to spend on monitoring firm governance, their fees would rise, they would lose investors, and perhaps most galling of all, increases in firm value that followed would necessarily be shared with their competitors' funds. Much of the literature reflects this view.[45] Nevertheless, other thoughtful commentators argue that the competitive pressures facing passive funds to attract more investor capital, the potential economies of scale and scope in monitoring arising from their size, their relatively large stakes in investee firms, and public expectations and reputational incentives suffice to motivate managers of passive portfolios to play an active and benevolent role in corporate governance.[46] These factors may also lead passive funds to pursue general good governance initiatives that might increase firm value across many firms in their portfolios rather than in any particular company.

43. See, e.g., *Proxy Voting and Shareholder Engagement FAQ*, BlackRock, Inc. (Jan. 2020); Vanguard, "Principles and Policies," https://about.vanguard.com/investment-stewardship/principles-policies/).

44. See Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 Col. L. Rev. 2029 (2019); John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* (September 20, 2018), Harvard Public Law Working Paper No. 19-07.

45. See Bebchuk & Hirst, *supra* note 44. Further, Morley argues that coordination on activism within big asset managers is unlikely given the internal conflicts in fund families. See John D. Morley, *Too Big to Be Activist*, 92 S. Cal. L. Rev. 1407 (2019). The extent of concerns over benefits to competitor funds from activism is mitigated somewhat by the fact that there are more indices than U.S. stocks, so that a particular index fund may be narrow enough that there are few other funds tracking its exact composition.

46. See Coates, *supra* note 44; Marcel Kahan and Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders* (April 4, 2019). NYU Law and Economics Research Paper No. 18-39; Jill Fisch, Assaf Hamdani and Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. Pa. L. Rev. 17 (2019).

A less widely noted wrinkle in the voting of institutional shares in public companies is the widespread practice of share lending. The institution that owns or manages the shares often "lends" them (for a fee) to another entity for a short period of time.[47] This may be to "short" the stock or for other purposes too. These lending fees become an additional important source of revenue to institutions, especially for index funds which compete on offering wafer-thin fees to their investors. However, when this practice occurs around votes, then there is the very real prospect that the party entitled to vote may only be holding the shares for a very short period of time, or perhaps only for the purpose of voting, raising concerns similar to vote buying. (See side bar on the recent Gamestop Proxy Contest.)

6.8.1 Proxy Advisory Firms

Proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis, are key players in modern shareholder voting. They are for-profit entities providing recommendations to institutions on how they should vote on specific issues (e.g., whether to reappoint a director, de-staggering the board). Large institutional investors and asset managers often use their recommendations when developing their own voting policies, while others go further and pre-commit to follow their advice.[48] Proxy advisory firms can thus sway a large section of voting shareholders, which makes understanding their incentives important. Although their compensation doesn't depend on returns or share price movements per se (they usually charge subscription-based fees to receive their recommendations),[49] some worry whether they suffer from conflicts of interest or other considerations affecting their objectivity. This and related concerns led to the SEC's promulgation of a new set of proxy rules in July 2020, which many argue encumber proxy advisory firms in providing voting recommendations. See Section 6.9.1 below.

6.8.2 Institutional Shareholder Activists

Over the last two decades, 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 unlike the typical large passive index fund. Their strategy can be as simple as seeking to dividend

47. See Reena Aggarwal, Pedro A.C. Saffi & Jason Sturgess, *The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market*, 70 J. Fin. 2309 (2015).

48. See Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 Tex. L. Rev. 983, 992 (2020); David F. Larcker, Allan L. McCall & Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J. L. & Econ. 173 (2015).

49. See Andrey Malenko & Nadya Malenko, *Proxy Advisory Firms: The Economics of Selling Information to Voters*, 74 J. Fin. 2441 (2019).

excess cash on the balance sheet 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 the activist will approach the CEO or the board to demand fundamental changes in the company's business plan. 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, Section 6.9.2 below). The following excerpt explains why some commentators see these hedge funds as well positioned 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. . . 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. . . 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. . .

Thus, unlike mutual funds, hedge funds benefit directly and substantially from achieving high absolute returns. For successful managers, the resulting profits can be extraordinarily high.

The debate on the effects of hedge fund activism, which has parallels to that around hostile takeovers in the 1980s, has generated an outpouring of empirical work focusing on the central question of whether hedge fund activism encourages "short-termism" at the expense of the long term. Although most scholars find a positive immediate stock price response to activism, greater debate accompanies discussions on longer-term effects on firm value and on stakeholders and society. In an influential 2015 article, Bebchuk, Brav, and Jiang argue that there is scant evidence for negative long-term firm value effects of hedge fund activism and rather good evidence for positive long-term effects on firm value.[50] More recent work expresses greater skepticism on the longer-term firm value gains[51] or finds that the longer-term gains are more likely when activism leads to acquisitions or the formation of significant ownership blocks.[52] Research on the effects of activism outside of the target firm is quite recent and is beginning to generate its own unresolved debate.[53] Given the intense interest in these questions, perhaps the wisest thing to say is stay tuned.

SIDE BAR ON GAMESTOP'S 2020 PROXY CONTEST AND SECURITIES LENDING:

Dawn Lim, "How Investing Giants Gave Away Voting Power Ahead of a Shareholder Dispute," ***Wall Street Journal***, **June 10, 2020**

GameStop Corp. shareholders vote this week to resolve a fight over the embattled videogame retailer's board. But the company's largest investors won't cast much of a vote.

The three biggest money managers in GameStop reported that their funds held some 40% of shares in the first quarter. When it was time to commit to voting, they controlled roughly 5% of ballots, according to count estimates reviewed by The Wall Street Journal. . . .

The main reason for the disparity is that BlackRock Inc. Vanguard Group and Fidelity Investments [and others] chose to loan out substantial GameStop shares for the rich stream of fees their investors stood to gain, according to people with knowledge of the matter. . .

While investing giants have raised their voices to prod companies to address society's most pressing problems, they sometimes decide not to control the ballots that drive change. . .

50. See Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 Col. L. Rev. 1085 (2015).

51. See Ed deHaan, David Larcker & Charles McClure, *Long-Term Economic Consequences of Hedge Fund Activist Interventions*, 24 Rev. Account. Stud. 536 (2019); John C. Coffee & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 1 Annals of Corporate Governance 1 (2016).

52. See Matthew Denes, Jonathan M. Karpoff & Victoria McWilliams, *Thirty Years of Shareholder Activism: A Survey of Empirical Research*, 44 J. Corp. Fin. 405 (2017); K. J. Martijn Cremers, Erasmo Giambona, Simone M. Sepe & Ye Wang, *Hedge Fund Activism and Long-Term Firm Value* (May 28, 2020) (arguing that the gains are from hedge funds' superior trading skills, not governance changes).

53. One recent study finds positive spillovers on non-targeted firms. See Nickolay Gantchev, Oleg R Gredil & Chotibhak Jotikasthira, *Governance Under the Gun: Spillover Effects of Hedge Fund Activism*, 23 Rev. of Fin. 1031 (2019). Another paper finds negative effects on social performance. See Mark R. DesJardine & Rodolphe Durand, *Disentangling the Effects of Hedge Fund Activism on Firm Financial and Social Performance*, 41 Strategic Mgmt. J. 1054 (2020).

"Securities lending has changed the way ownership is understood," said Richard Grubaugh, senior vice president of D.F. King & Co., a firm that assists companies with shareholder outreach. "Ownership and economic interests are decoupled from voting." . . . Some SEC staffers were worried there wasn't yet full visibility into how securities lending affects voting patterns, said a person familiar with the matter. . .

The extent to which investment firms forgo votes for lending fees isn't known. Meanwhile, public companies rely on proxy solicitors to stitch together estimates . . . and information on voting power tied to different investors is typically kept under wraps . . .

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 1934 Act), chiefly §14(a)-(c), which regulate virtually every aspect of proxy voting in public companies. These provisions support an array of rules promulgated and enforced by the Securities and Exchange Commission.

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 anti-fraud 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 1934 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.[54] 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 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*[55] illustrates the point. In that case, a request to 42 stockholders of a large public company to join in a petition 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.[56]

54. 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.

55. 360 F.2d 692 (2d Cir. 1966).

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

In 1992, the SEC responded by amending the rules in several important ways. In general, the 1992 amendments to Regulation 14A limited the term "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. For instance, 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 changes did not exempt investors from Rule 14a-9 (discussed below), which prohibits false or misleading statements in connection with written or oral solicitations.[57]

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 (see 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

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

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 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 derivatives 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 9-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 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).

NOTE ON NEW PROXY VOTING ADVICE RULES

In July 2020, the SEC adopted rules that impose substantial regulatory burdens on proxy advisory firms as well as subjecting them to new liability risks. These rules were conspicuously targeted at ISS and Glass Lewis. They follow the structure of the proxy rules by treating the recommendations of proxy advisors as proxy "solicitations" that are potentially subject to antifraud liability and the full panoply of disclosure rules under Regulation 14A. Rule 14a-1(l).[58] They then exempt proxy advisors from most of the 14A disclosure mandates providing that these advisors comply with an alternative set of requirements. Rules 14a-2(b) and 14a-2(b)(9). These new disclosure mandates include: (1) requiring detailed disclosure of material conflicts of interest in the proxy advice, (2) providing the company to which the advice relates the opportunity to review the proxy advice and provide feedback before, or simultaneously with, its issuance to investors as well as notifying investors that the firm intends to, or has provided, a response, and (3) permitting the firm to have its views made available to readers of the proxy advice via hyperlink.

In addition, the new rules illustrate when failure to disclose material information might be misleading and hence subject to liability. For instance, a failure to disclose information on the proxy advisor's methodology, sources of information, conflicts of interest, and use of standards materially different from those approved by the SEC. Rule 14a-2(b)(9). The accompanying SEC release also notes that advisors may need to disclose "business practices . . . that might reasonably . . . call into question [the advice's] objectivity and independence [for example] selectively consulting with certain clients before issuing [a recommendation]."

Finally, supplemental advice accompanying the rules indicates that investment advisors (e.g., asset managers), who are among the principal consumers of proxy advisor recommendations, have a duty to consider firm responses to these recommendations before voting their shares.[59]

The new proxy advisor rules were sharply contested prior to their adoption.[60] On one hand, proxy recommendations released to the public were not

58. See *Final Rule: Exemptions from the Proxy Rules for Proxy Voting Advice*, SEC (July 22, 2020).

59. See *Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers*, available at: https://www.sec.gov/rules/policy/2020/ia-5547.pdf.

60. See Council of Institutional Investors, Comment Letter, January 30, 2020; Business Roundtable Public Comments to SEC on Amendments to Exemptions from the Proxy Rules for

always well informed, and the business model in which advisors promulgate governance standards while charging clients for advice on corporate governance flags an apparent — albeit a transparent — conflict of interest. On the other hand, without the low-cost recommendations of ISS and Glass Lewis, institutional investors might not have perspective on governance matters other than those of management.

QUESTIONS

1. It's too early to assess the long-term effects of the new proxy advisor rules. But will these effects be positive if the new rules discourage proxy advisors from providing recommendations in contested proxy battles? Are the policy considerations here different from those in other contexts where legal rules can influence the outcome of proxy contests, for example, the regime for reimbursing proxy solicitation costs addressed in the *Rosenfeld* case above?

2. The 1992 amendments to the proxy rules are often described as deregulating the exchange of views and information among shareholders. Could the new proxy advisor rules be described as re-regulating communication among key actors in corporate governance?

6.9.2 Activist Investors and the Short Slate Proxy Contest

Classically, proxy contests involve an effort by an insurgent group to replace the existing board through election. Completely aside from their regulatory costs, proxy contests for control are, however, hard to win. This is largely because existing investors are often suspicious about delivering control of the company to an unknown new group or individual. For this reason tender offers for control — which offer cash instead of promised reforms — rather than proxy contests became the more heavily used technique for hostile attempts to change corporate control. But over the recent past the proxy contest has returned again, thanks to the innovation of the short slate proxy contest, which was made possible by a 1992 change in SEC rules as well as Delaware case law that makes tender offers without board approval very difficult.

One of the most significant developments of the twentieth century in corporate governance has been the emergence of so-called activist hedge fund investors. Today, no company can hope to escape the attention of activists on the basis of size alone. It is reported that there are more than 100 hedge funds that have engaged in activism, with well over an estimated $100

Proxy Voting Advice, February 3, 2020; SEC Commissioner Robert J. Jackson, Jr., *Statement on Proposals to Restrict Shareholder Voting*, U.S. Securities and Exchange Commission, November 5, 2019.

billion of assets under management. But their real power comes not just from their own capital under management but from marshalling the support of the much larger institutional investors and asset managers, among others.

Typically, the activist fund will have prepared a thoughtful whitepaper outlining the basis for the change in policy or practice that it seeks. These sorts of suggestions from outsiders are almost always resisted by incumbent boards. Thus, a major challenge for activist investors is to find levers that will get their proposals serious attention from senior management and the board. The principal way this is done is through the threat or the execution of a short slate proxy contest.

A short slate proxy contest is one in which the insurgent offers nominees for only a minority of board positions; the other positions on the insurgent's proxy card are filled in with some of the company's nominees. This technique is made possible by SEC regulations that permit the short slate proponent to round out its proxy card with nominees from the management slate.[61] The short slate proxy contest offers the great advantage of giving dissatisfied shareholders an opportunity to "shake up" existing management without turning control over to the activists completely. Thus, successful short slate contests are much more frequent than contests for the whole board, which are rare today. Interventions by activists have grown from just 29 in 2000 to nearly 300 in 2018, according to Wachtell Lipton memoranda on the subject. And these efforts meet increasing success. In approximately 50 percent of their efforts activists win board representation, either through a vote or settlement.

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 of 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 the 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.

61. See Securities Exchange Act Rule 14a-4(d)(4).

Regulation 14A provides a number of specific grounds to permit corporations to exclude shareholder-requested matter from the corporation's proxy solicitation materials. The most important is Rule 14a-8(i) which lists 13 grounds that permit firms to exclude proposals from the company's solicitation materials.[62] These grounds 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. 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.

Most Rule 14a-8 shareholder proposals fall into one of two categories: corporate governance proposals or corporate social responsibility (CSR) proposals. Before 1985, Rule 14a-8 proposals were mostly about CSR, which embraced topics ranging from environmental policies to personnel practices. During the 1990s until around the mid-2010s, corporate governance proposals dominated. In the last few years, however, CSR proposals have come to outnumber governance proposals once again, and they have also received more shareholder support than ever, even if usually this support does not rise to the 50 percent level.

6.9.3.1 Corporate Governance Proposals

Hedge fund activists, labor unions, and others have 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. For example, Professors Randall Thomas and James Cotter found that 72 percent of Rule 14a-8 proposals submitted between 2002 and 2004 dealt with corporate governance issues.[63] Although these proposals are typically drafted in

62. Shareholder proposals must also 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)).

63. See James F. Cotter & Randall S. Thomas, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. Corp. Fin. 368, 373-374 (2007) (Table 1). These proposals addressed issues ranging from executive compensation (27 percent of the Thomas & 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).

a precatory form; that is, as recommendations to the board of directors for adoption,[64] they remain a useful governance technique because they place the issue before shareholders at large and register their sentiment. Further, a large affirmative shareholder vote often has a dramatic effect even when a resolution is only precatory. Simply put, astute management may hesitate to offend a shareholder majority, even if its will is not binding. For instance, we noted above the stark decrease in staggered boards in S&P 500 companies (from more than 60 percent of all such firms in 2000 to approximately 10 percent in 2018), which appears to be almost entirely due to investor pressure tied to these proposals. Recent years have, however, witnessed fewer governance proposals because, for many companies, most of these battles have been won by now.

NOTE ON SHAREHOLDER PROXY ACCESS TO NOMINATE DIRECTORS

Few issues in corporate governance have been so warmly contested and for so long as the question of when, if at all, a shareholder should have the right 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 to be important. Management, on the other hand, has resisted this effort from the start. They claim 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 to promulgate a mandatory rule to govern all public companies. Since 2012, however, the effort to gain that access has proceeded company-by-company, largely in conjunction with urging accomodating changes in state corporate law. Our treatment of this lengthy and complex issue is necessarily summary.

It was always possible for a charter or bylaw provision to mandate that a company provide its shareholders with access to its proxy under some conditions.[65] But such access was not generally available because (1) management did not favor it and thus did not suggest it, and (2) SEC regulations

64. We note in passing that the SEC has effectively encouraged shareholders to frame corporate governance resolutions in a precatory form. Precatory resolutions sidestep questions concerning the scope of shareholder authority under state law. See the note following Rule 14a-8(i)(1).

65. 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.

barred shareholders from placing an issue on the company's proxy to allow a shareholder vote. Thus, no shareholder in a public company could put such a bylaw up for a shareholder vote without shouldering the cost of printing and distributing her own proxy solicitation materials. The point of the early SEC prohibition on including shareholder nominees in the company proxy was presumably to avoid confusion about who management's nominees really were.

Beginning in 2007, after alternate circuit court decisions and SEC rule changes, the ability of activists to implement proxy access regimes through Rule 14a-8 proposals has largely been left to private ordering. Institutional investors — led by state pension funds and labor union pension funds — have waged a sustained effort to persuade 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 ownership 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 now settled around a 3 percent, three-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 (typically April to June) there were just 16 firms that had faced a shareholder vote on proxy access, and of these proxy access had won shareholder support in ten. But 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/three-year thresholds (e.g., GE, Bank of America) or 5 percent/three-year thresholds (e.g., Priceline). Other companies resisted and recommended against a shareholder proposal: some prevailed (e.g., Apple, Coca-Cola), while others did not. By 2019, roughly 70 percent of S&P 500 companies had proxy access provisions in their charters.

6.9.3.2 Corporate Social Responsibility Proposals

There is a long tradition of "pro-social" activism that seeks to change corporate behavior in ways that their proponents believe are socially beneficial. Should shareholders have a federal right to place proposals on the corporation's proxy statement that urge the board to comply with fixed carbon emission standards or to nominate at least five women candidates to the company's board of twelve directors at the next annual shareholders meeting? 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 child labor and that a shareholder group believes this is immoral and bad for business (arguing the corporation will suffer long-term reputational damage). Can these shareholders include a precatory resolution in the company's proxy requesting that the board cease doing business with this suspect 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

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. While the reasons for adopting the *Cracker Barrel* interpretation continue to have some validity, as well as significant support in the corporate community, we believe that [its] reversal . . . is warranted . . . 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. . . .

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. . . 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 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. . . .

After reading this analysis, are you clear what the SEC's criteria for inclusion on management's proxy were after it withdrew the *Cracker Barrel* no-action letter and returned to a "case-by-case analytic" for determining whether issues relating to employment practices were excludable or of sufficient importance to be an appropriate subject of a Rule 14a-8 resolution?[66] As you might expect, this distinction has continued be murky.

For some years, the SEC had come to emphasize micromanagement as a key issue in its decisions to grant no-action letters. In 2018, the SEC's Division of Corporate Finance doubled down by giving "micromanagement" pride of place in a more general discussion of its exclusion policies.[67] One example it provided noted the inappropriate specificity of an Apple shareholder proposal recommending that the technology giant reach net-zero greenhouse gas emissions by 2030. During the 2019 proxy season, micromanagement was among the reasons the SEC cited for granting 64 of the 105 no-action letter requests it received relating to environmental and social matters (E&S).[68] The SEC also granted such requests when shareholder proposals recommended compliance with parts of the Paris Climate Agreement on the grounds that these proposals sought to tie management's hands with respect to complex matters of business policy and implementation.[69]

66. See SEC Release No. 34-40018, Fed. Sec. L. Rep. (CCH) ¶86,018.

67. See SEC Staff Legal Bulletin No. 14J(CF), October 23, 2018. Available at: https://www.sec.gov/corpfin/staff-legal-bulletin-14j-shareholder-proposals.

68. See Richard Alsop & Yoon-Jee Kim, Shearman & Sterling LLP, *Shareholder Proposals 2019 — ESG No-Action Letter Trends and Strategies*, Harvard Law School Forum on Corporate Governance, March 25, 2020.

69. See id. (referring to no-action letter requests by, among others, ExxonMobil Corporation, The Goldman Sachs Group, Inc., and Wells Fargo & Company).

Today, corporate social responsibility (CSR) and E&S are major concerns for large companies and their boards. In the 2020 proxy season, shareholders submitted over 400 E&S proposals, which outnumbered governance-related proposals. Most of these addressed political spending, climate change, gender and race diversity, and workplace environment.[70] The percentage of these proposals that receive majority shareholder support has been increasing.[71] In addition, many other resolutions are withdrawn because their proponents settle with management over changes in company policies. Such settlements have become increasingly common. The broad range of E&S proposals testifies not only to their rising popularity, but also to the emergence of new activist groups that rely on the shareholder proposal system.[72] We discuss broader issues related to E&S proposals in Chapter 8.

However, the shareholder proposal system also faces significant new challenges. The same package of proposed SEC reforms that led to the recent regulation of proxy advisors also targeted Rule 14a-8 shareholder proposals. The SEC adopted these rules on September 23, 2020. Among the changes they make are increasing the share ownership threshold that proponents must satisfy to be eligible to submit Rule 14a-8 proposals,[73] increasing the threshold of prior shareholder support required to resubmit proposals that had previously failed to pass,[74] and allowing companies to exclude resubmitted proposals whose support had declined over their past two submissions. The last two of these rule changes are particularly likely to affect E&S proposals, which often see rising shareholder support over the course of several annual submissions. As one might expect, these new rule changes are almost as warmly contested as the SEC's newly adopted proxy advisory rules.[75]

70. See *Proxy Preview 2020*, March 19, 2020; Hannah Orowitz & Brigid Rosati, *An Early Look at the 2020 Proxy Season*, Harvard Law School Forum on Corporate Governance, June 10, 2020.

71. Thus far, in the 2020 cycle, 7 out of 23 E&S proposals have passed (double the percentage that passed in 2019), including one where Chevron shareholders voted to recommend enhanced disclosure of climate lobbying. Even this understates the number because some governance proposals are really tied to E&S issues, such as two proposals recommending splitting the board chair and CEO positions which passed this year. Orowitz & Rosati, *supra* note 70.

72. See Paul Rissman & Andrew Behar, *A Successful Season for SASB-Based Shareholder Resolutions*, Harvard Law School Forum on Corporate Governance, June 12, 2020. Activism is also going "global." See, e.g., Marco Becht et al., *Returns to Hedge Fund Activism: An International Study*, 30 Rev. Fin. Stud. 2933 (2017).

73. A shareholder would need to show a continuous holding of either $2,000 of a company's voting securities for at least three years, or "$15,000 of these securities for two years, or $25,000 for at least one year." *See Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8: Proposed Rule*, SEC (November 5, 2019). This contrasts with the existing rule requiring a continuous holding of $2,000 of these securities for at least one year.

74. See id, at 51 which changes the thresholds for resubmission from 3 percent (for the first time a proposal is voted on), 6 percent (for the second time), and 10 percent (for the third time) to 5, 15, and 25 percent, respectively.

75. See, e.g., Council of Institutional Investors, Comment Letter, January 30, 2020; Business Roundtable Public Comments to SEC on Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8, February 3, 2020; Jackson, *supra* note 60.