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# Voting Power Without Responsibility or Risk-- How Should Proxy Reform Address the Decoupling of Economic and Voting Rights?

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# VOTING POWER WITHOUT RESPONSIBILITY OR RISK: HOW SHOULD PROXY REFORM ADDRESS THE DECOUPLING OF ECONOMIC AND VOTING RIGHTS?

ROBERTA S. KARMEL\*

## I. INTRODUCTION

THE regulation of proxy voting resides at an uncomfortable intersection between federal and state law. Although state law controls the holding of annual meetings to elect directors and the corporate governance aspects of proxy voting, federal securities laws control the solicitation of proxies. Since at least 1977, shareholder activists have been trying to persuade the Securities and Exchange Commission (SEC) to revise the rules governing proxy solicitations disseminated by a public corporation to allow competing shareholder nominees to be included in opposition to the board of directors' nominees. Although the SEC has proposed rules to this effect, such rules have not yet been adopted.<sup>1</sup> The current version of a proposed proxy access rule is no less controversial than its predecessors.<sup>2</sup>

In the meantime, the growth of derivatives and various trading strategies by some investors have led to a decoupling of economic and voting rights in public corporations, permitting proxy voting by shareholders with little or no economic interest in the shares they vote. Such voting is referred to as "empty voting." If the SEC adopts a proxy reform rule to allow competing shareholder nominees to appear on the same ballot, the problems of empty voting in a proxy contest are likely to be exacerbated unless the SEC addresses this issue.

But the question of whether economic rights need to be aligned with voting rights in order for voting rights to be valid would appear to be a state law, rather than a federal law, issue. Although the SEC could reform its disclosure regulations under the Williams Act to compel better disclosure of empty voting, its authority to compel economic rights to match voting rights is questionable, although probably could be made a condi-

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1. For a discussion of the proposed SEC rules, see *infra* notes 92-94, 96-100, and accompanying text.

2. See Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024 (June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249, and 274) [hereinafter Facilitating Shareholder Director Nominations]; Jeffrey McCracken & Kara Scannell, *Fight Brews As Proxy-Access Nears*, WALL ST. J., Aug. 26, 2009, at C1.

tion to proxy access. Further, a recent Delaware Supreme Court case and recently enacted Delaware legislation suggest that Delaware is prepared to referee the skirmishes between institutional shareholders and corporate boards with regard to shareholder nominations.<sup>3</sup> Therefore, even if the SEC has authority with regard to granting some shareholders access to a company's proxy, there is a policy question as to whether such regulation of corporate internal affairs is wise.<sup>4</sup>

The shareholder franchise is regarded as a key accountability mechanism under both state and federal law. In *Blasius Industries, Inc. v. Atlas Corp.*,<sup>5</sup> Chancellor Allen declared that "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. Generally, shareholders have only two protections against perceived inadequate business performance. They may sell their stock . . . or they may vote to replace incumbent board members."<sup>6</sup> Accordingly, matters regarding "the integrity of the shareholder voting process" raise special considerations involving the power of shareholders and the power of the board, and cannot be defended under the business judgment rule.<sup>7</sup> Similarly, the U.S. Supreme Court has viewed the SEC's power to regulate the proxy solicitation process as an important protection for shareholders in all public companies, intended to promote the free exercise of the corporate franchise.<sup>8</sup> Empty voting seriously undermines the shareholder franchise. Yet, neither state nor federal law has thus far deprived investors who do not have an economic interest in shares the right to vote such shares.

Part II of this Article describes empty voting strategies and addresses relevant state law on the alignment of economic and voting rights. Part III sets forth the story of the SEC's efforts to deal with shareholder demands to oppose company nominees for directors and put competing shareholder nominees on the company's proxy. It also addresses Delaware's evolving response to the issues involved. Part IV describes the SEC's failure to address the separation of economic and voting interests in either its

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3. See An Act To Amend Title 8 of the Delaware Code Relating to the General Corporation Law, H.R. 19, 145th Gen. Assem. (Del. 2009). This bill was signed into law on April 10, 2009. See Yin Wilczek, *Proxy Access Amendments to Del. Code Signed into Law; Provisions Effective Aug. 1*, 41 Sec. Reg. & L. Rep. (BNA) No. 16, at 728 (Apr. 20, 2009). For a further discussion of these recent developments in Delaware, see *infra* notes 124-34 and accompanying text.

4. See Norman Veasey et al., *Federalism vs. Federalization: Preserving the Division of Responsibility in Corporation Law* 44-46 (Yale Law Sch. Ctr. for Law, Econ. & Pub. Policy, Research Paper No. 324), available at <http://ssrn.com/abstract=878246>; Letter from James L. Holzman, Chair, Council of the Corp. Law Section, Del. State Bar Ass'n, to Elizabeth M. Murphy, Sec'y, U.S. Sec. and Exch. Comm'n. (July 24, 2009), available at <http://sec.gov/comments/s7-10-09/s71009-65.pdf>.

5. 564 A.2d 651 (Del. Ch. 1988).

6. *Id.* at 659.

7. *Id.*

8. See *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 381 (1970); *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964).

tender offer or proxy rules. This issue goes to the heart of this Article—if the SEC decides to change its regulation of the proxy format for public company solicitations so that shareholders have access to the company's proxy, how will the SEC define the term "shareholder" and will such definition include or exclude empty voters? Further, even if the SEC is able to sensibly address this issue, does the agency have the authority to adopt such a regulation?

While proxy access is generally viewed as a war between institutional shareholders—particularly union pension funds and management—the issues that need to be addressed and clarified are far broader than this simplistic political construct. Shareholder voting is heavily relied upon to justify corporate structure and governance in the United States, but the mechanics of such voting are a mess and do not properly protect the shareholder franchise or truly legitimize the power of corporate directors and managers. In part, this is because the SEC has been more concerned about market issues, such as securities clearance and settlement, than about providing for direct communications between corporate boards and managers and their shareholders. Further, the hope that Internet voting would close the communications gap between issuers and their shareholders has not materialized. Also, derivatives and institutionalization have changed the nature of shareholder rights, and the huge stock loan business engaged in by institutional investors has made their investment frequently discontinuous insofar as voting rights are concerned. For these reasons, rhetoric analogizing the corporate franchise to the political franchise and advocating shareholder access obfuscates the realities of the proxy voting machinery.

When the SEC's 2003 shareholder access rule was proposed, I had reservations about such a rule because, unlike directors, shareholders of public companies do not owe any fiduciary duties to other shareholders unless they exercise control.<sup>9</sup> Further, while shareholders wishing to use a shareholder access rule to nominate directors on the company's ballot might not be controlling shareholders, putting up directors in opposition to the company's slate is an action that could eventually lead to a change of control. Through its rule-making proposals, the SEC has attempted to confine proxy access to large, long-term shareholders that disclaim a change of control agenda.<sup>10</sup> But how can such shareholders be defined in a world where empty voting is allowed and often not well-disclosed?

An SEC rule permitting some shareholder access to management's proxy is probably inevitable during the Obama administration. The 2008 election has given greater clout to unions and the union pension funds

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9. See Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1, 2 (2004); Letter from Roberta S. Karmel to Jonathan G. Katz, Sec'y, U.S. Sec. and Exch. Comm'n (Apr. 12, 2004), available at <http://www.sec.gov/rules/proposed/s71903/rkarmel041204.pdf>.

10. For a discussion of these SEC rule-making proposals, see *infra* notes 92-94, 96-100, and accompanying text.

that are pushing for shareholder access. Further, the financial crisis and the stock market collapse have fueled shareholder grievances and lend credence to claims that shareholders should have a greater say in the election of directors. Also, bills that have been introduced in Congress to grant shareholder access may influence the SEC to pass a rule to this effect.<sup>11</sup> If a shareholder access rule goes forward, one of the issues the SEC will have to address is which shareholders should be granted such access.

I believe that only substantial, long-term investors are likely to exert a positive influence on the election process, and that such shareholders should have some fiduciary duties to the corporation and other shareholders. Accordingly, I recommend that the SEC confine proxy access to large shareholders with a continuing economic interest in a corporation's shares. I also recommend that the SEC remove empty or discontinuous voters from any definition of shareholders eligible to propose by-law changes with regard to nominations, or to nominate directors on the company ballot. Further, because of the tenuous federal interest in director nomination procedures, it would be best if the SEC coordinates its rules with the evolving Delaware approach to proxy access.

## II. RELEVANT STATE LAW PRINCIPLES

### A. *Aligning Economic and Voting Interests*

#### 1. *The Voting Trust Controversy*

In the nineteenth century, courts condemned the separation of share ownership and voting rights as contrary to public policy. Accordingly, voting trusts were invalidated. In *Shepaug Voting Trust Cases*,<sup>12</sup> a frequently cited early decision striking down a voting trust, the court reasoned that voting "is the duty that one stockholder in a corporation owes his fellow stockholder, and he cannot be allowed to disburden himself of it in this way," even though he may choose not to perform his duty to vote.<sup>13</sup> According to one respected commentator, the usual six justifications for declaring voting trusts invalid were that: (1) a voting trust is the same as a proxy, and proxies are generally required to be of limited duration; (2) voting power should not be divorced from beneficial ownership; (3) it is a breach of duty by a shareholder to abdicate his voting responsibilities; (4) it is contrary to public policy to place control of a corporation in someone

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11. See Shareholder Bill of Rights Act, S. 2460, 107th Cong. § 5(a) (2002); Corporate Pay Responsibility Act, S. 1198, 102d Cong. § 3(a) (1991); Protection of Shareholders' Rights Act of 1980, S. 2567, 96th Cong. § 8(a) (1980). Mary Schapiro, the current Chair of the SEC, represented in connection with her confirmation that she supports giving shareholders proxy access. See Malini Manickavasagam et al., *Schapiro Agrees SEC Must Reconsider Key Areas Including Proxy Access*, *IFRS*, 41 Sec. Reg. & L. Rep. (BNA) No. 5, at 149 (Feb. 2, 2009).

12. 24 A. 32 (Conn. Super. Ct. 1890).

13. *Id.* at 41.

with no pecuniary interest; (5) the majority may be subjected to control by a minority; and (6) the voting trustee may abuse his power.<sup>14</sup>

Despite these views, at the beginning of the twentieth century many states—including New York<sup>15</sup> and Maryland<sup>16</sup>—passed laws to make limited duration voting trusts lawful, and courts found such a separation of voting and economic power to be lawful.<sup>17</sup> These statutes and cases arose as a matter of economic and industrial necessity as voting trusts became useful to achieve continuity of management, to work out plans of reorganization, and for other purposes.<sup>18</sup> Then, from 1912 to 1913, a crusade against the use of voting trusts and pooling agreements was fomented by the Pujo Committee, which argued that they should be declared illegal *per se*.<sup>19</sup>

This argument resonated with some courts that then declared voting trusts illegal.<sup>20</sup> For example, in *Luthy v. Ream*,<sup>21</sup> the court reasoned that “each stockholder has the right to demand that every other stockholder . . . shall have the right to exercise at each annual meeting his own judgment as to the best interest of all the stockholders, untrammelled by dictation and unfettered by the obligation of any contract.”<sup>22</sup>

In the 1920s, the validation of voting trusts resumed through legislation. Delaware, Florida, Nevada, New Jersey, Arkansas, Ohio, and Louisiana passed legislation approving voting trusts. Between 1929 and 1933, ten more states followed suit.<sup>23</sup> The first Delaware case on the validity of voting trusts was decided in 1932, where the court held that because the legislature had passed a statute permitting such trusts, the parties could not raise a public policy argument against them.<sup>24</sup>

Voting trusts were a popular device to protect the interests of creditors, and the Depression and consequent reorganizations apparently added impetus to laws and court decisions validating voting trusts.<sup>25</sup> In addition, the theory that corporate stockholders were entitled to have the

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14. See HENRY WINTHROP BALLANTINE, *MANUAL OF CORPORATION LAW AND PRACTICE* 587 (1930).

15. See 1892 N.Y. Laws, c. 687, § 20; see also 1901 N.Y. Laws, c. 355, § 1 (codified at N.Y. BUS. CORP. LAW § 621 (McKinney 2003)).

16. See 1908 Md. Laws art. 23, c. 240, § 77.

17. See, e.g., *Brightman v. Bates*, 55 N.E. 809 (Mass. 1900); *Chapman v. Bates*, 47 A. 638 (N.J. 1900); *Carnegie Trust Co. v. Security Life Ins. Co.*, 68 S.E. 412 (Va. 1910).

18. See I. Maurice Wormser, *The Legality of Corporate Voting Trusts and Pooling Agreements*, 18 COLUM. L. REV. 123, 123 (1918).

19. See *id.* at 126.

20. See *id.* at 133.

21. 110 N.E. 373 (Ill. 1915).

22. *Id.* at 376.

23. See Thomas W. Watkins, *The Development of Voting Trust Legislation*, 35 U. DET. L.J. 595, 598-99 (1958).

24. See *Chandler v. Bellanca Aircraft Corp.*, 162 A. 63, 66-67 (Del. Ch. 1932).

25. See Watkins, *supra* note 23, at 599.

benefit of the judgment of other stockholders in the selection of a board of directors was rendered obsolete because the typical large public corporation had thousands of shareholders in all parts of the country.<sup>26</sup> But today, with the institutionalization of the securities markets, shareholders are again more concentrated and in touch with one another on corporate governance issues. Accordingly, policies concerning separation of voting and economic interests ought perhaps to be reconsidered.

## 2. *Weighted Voting*

Another issue related to empty voting is the "one share, one vote" principle. In 1897, the Delaware Constitution provided that every share of common stock should have one vote.<sup>27</sup> The constitution was then changed and thereafter the Delaware courts permitted capitalization structures where some classes of common stock had more votes per share than other classes.<sup>28</sup>

The abuses by public corporations with weighted voting shares in the 1920s led to a campaign against such capitalization structures. Instead of leading to a change in state or federal law, however, this campaign led to a change in the listing requirements of the New York Stock Exchange (NYSE), so that between 1926 and 1986 all NYSE-listed companies were required to have a one share, one vote capital structure.<sup>29</sup> Accordingly, in 1983 Professors Easterbrook and Fischel were able to write that "[the] most basic statutory rule of voting is the same in every state. It is this: All common shares vote, all votes have the same weight, and no other participant in the venture votes, unless there is some express agreement to the contrary."<sup>30</sup> The reason they gave for this regime was that shareholders were the residual claimants to the firm's income, and unless each share has equal voting rights there will be an agency cost of management.<sup>31</sup>

In the 1980s, however, many stalwart exchange-listed companies engineered a dual class recapitalization in order to fend off unwelcome takeovers or for other reasons, and some firms went public with dual common stock classes. Because the American Stock Exchange permitted such firms to be listed, this competitive threat caused the NYSE to change its listing rules and also allow companies with dual class capitalizations to be listed. The most common form of such a corporation involved a class of common

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26. See *Mackin v. Nicollet Hotel, Inc.*, 25 F.2d 783, 786 (8th Cir. 1928).

27. DEL. CONST. of 1897, art. IX, § 6 (repealed 1903).

28. See *Providence & Worcester Co. v. Baker*, 378 A.2d 121, 123 (Del. 1977).

29. This was in Section 313 of the NYSE Listed Company Manual as it existed in 1985, but it no longer exists. See Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 687-88 (1986).

30. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 408 (1983).

31. See *id.* at 409.

stock with ten votes per share to be held by insiders, and a class of common stock with one vote per share to be held by public shareholders.<sup>32</sup>

Under the Securities Exchange Act of 1934 (Exchange Act), the SEC was required to approve this rule change.<sup>33</sup> Because of widespread interest in this matter, the SEC held hearings and tried to negotiate a uniform voting rights rule for adoption by the NYSE, American Stock Exchange, and NASDAQ. This effort failed, so the SEC promulgated Rule 19c-4 prohibiting the exchanges and NASDAQ from listing any common stock of a firm that issues “any class of a security, or takes other corporate action, with the effect of nullifying, restricting, or disparately reducing the per share voting rights of holders.”<sup>34</sup> This rule would have protected shareholders of companies that had a one share, one vote regime, but would not have prevented other dual class corporations from going public or listing.

In *Business Roundtable v. SEC*,<sup>35</sup> the U.S. Court of Appeals for the D.C. Circuit struck down Rule 19c-4 as going beyond the SEC’s authority. The Court found that the SEC rule was a “rule” under Sections 19(b) and (c) of the Exchange Act, but that it failed to further the purposes of the statute.<sup>36</sup> The court reasoned that there was no indication in the Exchange Act that Congress intended to permit such a broad federal preemption over corporate governance and shareholder rights—matters traditionally left to state law.<sup>37</sup> The D.C. Circuit Court’s decision in the *Business Roundtable* case echoed the sentiments of the U.S. Supreme Court in *Santa Fe Industries, Inc. v. Green*,<sup>38</sup> which held that the anti-fraud provisions of the Exchange Act apply to manipulation or deception, but not to other breaches of fiduciary duty.<sup>39</sup> An important part of the Court’s rationale was that a contrary result would bring within Rule 10b-5 “a wide variety of corporate conduct traditionally left to state regulation.”<sup>40</sup> The Court was reluctant to federalize such a substantial portion of corporate law dealing with securities transactions in the absence of clear congressional intent.<sup>41</sup>

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32. See generally Jeffrey N. Gordon, *Ties that Bind: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1 (1988); Roberta S. Karmel, *Qualitative Standards for “Qualified Securities”: SEC Regulation of Voting Rights*, 36 CATH. U. L. REV. 809 (1987).

33. See 15 U.S.C. § 78s(b) (2006); 17 C.F.R. § 240.19b-4 (2009).

34. 17 C.F.R. § 240.19c-4.

35. 905 F.2d 406 (D.C. Cir. 1990).

36. *Id.* at 410-17.

37. See *id.* at 412-13. The exchanges then “voluntarily” adopted this rule as a listing standard and the SEC approved these new rules. See Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Exchange Act*, 47 BUS. LAW. 1461, 1472 n.70 (1992).

38. 430 U.S. 462 (1977).

39. *Id.* at 477.

40. *Id.* at 478-79.

41. *Id.* at 479.



### 3. *Vote Buying*

Another classic corporate law doctrine related to the prohibition of voting trusts was the prohibition against vote buying. Vote buying was generally held to be illegal as a matter of public policy because "each shareholder should be entitled to rely upon the independent judgment of his fellow stockholders."<sup>42</sup> In addition, a contract between stockholders to vote for a certain person as manager offends public policy.<sup>43</sup> The prohibition against vote buying was thus related to the doctrine that corporate offices cannot be purchased and sold.<sup>44</sup> One commentator has set forth three reasons for the historical view that vote buying was illegal per se: First, corporate vote buying was compared to political vote buying. Second, courts believed that shareholders had a duty to exercise independent judgment. Accordingly, selling votes was viewed as a fraud against other shareholders because small shareholders relied upon other shareholders to promote the best interest of all by promoting individual interests. Third, the courts believed that alignment of shareholder interests was necessary for avoiding collective action problems.<sup>45</sup>

In *Schreiber v. Carney*,<sup>46</sup> the Delaware Chancery Court ameliorated a per se rule of invalidity with regard to vote buying by holding that vote buying was not illegal absent a purpose to defraud or disenfranchise other shareholders.<sup>47</sup> Rather, because vote buying "is so easily susceptible of abuse it must be viewed as a voidable transaction subject to a test for intrinsic fairness."<sup>48</sup> *Schreiber* was followed by *Weinberger v. Bankston*,<sup>49</sup> where the settlement in a proxy contest included an agreement for the grant of irrevocable proxies. The court stated that "the validity of a transaction involving vote buying must be determined by reference to the object and purpose of the transaction. If the transaction is intrinsically fair and its object or purpose is not to defraud or disenfranchise stockholders, it will be upheld."<sup>50</sup>

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42. *Schreiber v. Carney*, 447 A.2d 17, 24 (Del. Ch. 1982); see also *Stott v. Stott*, 242 N.W. 747 (Mich. 1932) (discussing public policy against vote buying). But see Robert Charles Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776, 790-806 (1979) (weighing both advantages and disadvantages of vote buying).

43. See *Woodruff v. Wentworth*, 133 Mass. 309, 309 (1882).

44. See *Caplan v. Lionel Corp.*, 246 N.Y.S.2d 913, 915 (N.Y. App. Div. 1964), *aff'd*, 198 N.E.2d 908 (N.Y. 1964); *Brecher v. Gregg*, 392 N.Y.S.2d 776, 779-80 (N.Y. Sup. Ct. 1975).

45. See Kevin C. Cunningham, *Examination of Judicial Policy on Corporate Vote Buying in the Context of Modern Financial Instruments*, 64 N.Y.U. ANN. SURV. AM. L. 293, 311-14 (2008).

46. 447 A.2d 17 (Del. Ch. 1982).

47. *Id.* at 26.

48. *Id.* at 25-26.

49. No. Civ.A. 6336, 1987 WL 20182 (Del. Ch. Nov. 19, 1987) (unpublished opinion).

50. *Id.* at \*4.

Similarly, the court held in *Crawford v. Cincinnati Bell, Inc. (In re IXC Communications, Inc. Shareholders Litigation)*,<sup>51</sup> that voting buying arrangements were not illegal per se, but were illegal only if they defraud or disenfranchise shareholders. There, a merger agreement was conditioned upon an arrangement with IXC's largest shareholder, which owned sixty percent of IXC's stock. Per the merger agreement, the merger partner would buy one-half of this shareholder's stock for fifty dollars per share and the majority shareholder would support the merger. The court noted that the deal "had the appearance of a vote-buying agreement."<sup>52</sup> Following *Schreiber*, however, the court held that, "absent . . . deleterious purposes, a shareholder may commit his vote as he pleases."<sup>53</sup> The courts continue to apply this standard of heightened scrutiny. In *Hewlett v. Hewlett Packard Co.*,<sup>54</sup> a motion to dismiss was denied in a case alleging that the votes of an investment bank in a bitterly contested proxy fight were "bought" with a promise of future business.<sup>55</sup>

### B. Empty Voting

Empty voting has been defined as voting rights that substantially exceed net economic ownership.<sup>56</sup> A variety of strategies by investors can result in the decoupling of votes from shares, including: a stock loan where the borrower obtains the vote but the economic interest in the shares remains with the lender; an equity swap where the long equity side acquires economic ownership of shares, but no voting rights; or other hedging techniques by which an investor holds shares but hedges the economic risk (generally, through the use of derivatives).<sup>57</sup> Investors can also have greater economic ownership than voting rights but possess the ability to acquire the voting rights quickly if needed. These may be "hidden" or "morphable" voting rights.<sup>58</sup> In a variety of control contests, empty and hidden voting rights have changed the outcome of tender offers or proxy fights, and a number of these have been detailed by other scholars.<sup>59</sup> The primary concern of this Article is not the problems posed by empty and hidden voting in tender offers, but the likely problems empty voting will

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51. No. C.A. 17324, 1999 WL 1009174 (Del. Ch. Oct. 27, 1999) (unpublished opinion).

52. *Id.* at \*8.

53. *Id.*

54. No. Civ.A. 19513-NC, 2002 WL 549137 (Del. Ch. Apr. 8, 2002) (unpublished opinion).

55. *Id.* at \*7.

56. See Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications and Reforms*, 61 BUS. LAW. 1011, 1022 (2006).

57. See *id.* at 1015.

58. See *id.* at 1016, 1023.

59. See, e.g., *id.* at 1035-37; Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 655-59 (2008).

pose in proxy contests under a shareholder access rule formulated by the SEC.

The gist of these problems is that there are many different forms of stock ownership. Two examples highlight these problems very well. First, legal ownership is generally determined by the stock record, but the majority of shares in publicly traded companies is not registered in the name of the beneficial owner of shares, but rather in "street name." That is, the shares are held of record by brokers, banks, or their depositories. Most street name shares are registered in the name of Cede & Co., the name used by Depository Trust Company (DTC). DTC holds shares for brokers and banks and is therefore deemed the legal owner. Thus, under state law, DTC has the right to vote the shares even though it is only a custodian.<sup>60</sup> These arrangements are a necessary by-product of the need for efficient clearance and settlement of securities transactions in the absence of uncertificated shares maintained by an issuer.

Under SEC and NYSE rules, brokers deliver proxies to beneficial owners and request voting instructions.<sup>61</sup> Since 1937, NYSE Rule 452 permitted the broker to vote the shares for purposes of a quorum and for directors if the broker did not receive instructions by ten days before the date of the annual meeting. On July 1, 2009, however, the SEC approved a change to this NYSE rule so that in the absence of instructions from a beneficial owner a street name broker may no longer vote shares for directors.<sup>62</sup> This rule change will give institutional shareholders more power than their economic investments because many retail investors do not instruct their brokers on how to vote.<sup>63</sup> When the SEC instituted Internet voting of proxies as a default regime,<sup>64</sup> retail investors stopped voting proxies in large numbers.<sup>65</sup>

Stock loans highlight a second issue with stock ownership and voting. A beneficial shareholder has the right to instruct a record owner how to vote, and this right generally is practiced. However, if a beneficial owner lends shares to another holder, the beneficial owner may lose his or her

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60. See Request for Rulemaking Concerning Shareholder Communications (Apr. 12, 2004), <http://www.sec.gov/rules/petitions/petn4-493.htm>. See generally *Sadler v. NCR Corp.*, 928 F.2d 48, 50 (2d Cir. 1991) (explaining the share depository system).

61. 17 C.F.R. § 240.14b-1 (2009); NYSE Rules 450, 452.

62. See Order Approving NYSE Proposed Rule Change Relating to Broker Discretionary Voting, Exchange Act Release No. 60,215, 74 Fed. Reg. 33,293, 33,293 (July 1, 2009).

63. See *id.* at 33,298.

64. See 17 C.F.R. § 240.14a-16.

65. See Elisse B. Walter, Comm'r, SEC, Remarks Before the Practicing Law Institute: Restoring Investor Trust Through Corporate Governance, at 3-4 (Feb. 18, 2009), available at <http://www.sec.gov/news/speech/2009/spch021809ebw.htm> (discussing decline in shareholder participation). Apparently, shareholder participation in proxy voting by retail shareholders dropped from approximately 34% in the year prior to the Internet voting rule to 17% in the year it was first used. See *id.* at 4.

voting rights. In one Delaware case dealing with the distribution of shares in a class action settlement, the court held that both the shareholder lender and the borrower of stock were beneficial owners.<sup>66</sup> This common situation may lead to over-voting of shares.<sup>67</sup>

A stockholder may also have a short position against a long position, and be net short, although a legal owner of shares. This can occur through short sales or through the use of derivatives transactions. In a Delaware Chancery Court case, a net short seller who held both long and short positions in a stock was granted inspection rights.<sup>68</sup> In dicta, the court distinguished inspection rights from voting rights. Nevertheless, the case is at best ambiguous as to how, if at all, a court would curtail an empty voter in a proxy contest. In a different case brought as a derivative action, the Delaware Chancery Court held that an empty voter was not a proper plaintiff because it had not held shares continuously.<sup>69</sup>

As will be explained below, SEC reporting requirements under different provisions of the securities laws may define a shareholder broadly or narrowly for different purposes. This could not only create ambiguity under a shareholder access rule, but could result in the nomination of directors by empty voters.

### C. Shareholder Power to Adopt and Change By-Laws

The power to amend or repeal by-laws generally is shared by the board of directors and the shareholders.<sup>70</sup> Delaware Law specifically gives this power to shareholders, and it may not be divested by directors.<sup>71</sup> This power to amend a corporation's by-laws has been effectively used in imposing majority voting rules for directors. In addition, a recent important case suggests that shareholders are entitled to amend by-laws to obtain reimbursement for expenses in a proxy contest under certain circumstances.<sup>72</sup> These developments will be discussed in Part III (C) and (D) below, as a discussion of the SEC's proxy rules is necessary to understand these developments.

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66. See *In re Digex, Inc. S'holders Litig.*, No. Civ.A. 18336-NC, 2002 WL 749184, at \*2 (Del. Ch. Apr. 16, 2002) (unpublished opinion).

67. See *In re Deutsche Bank Sec. Inc.*, NYSE Hearing Panel Decision 05-45, at 4 (Feb. 2, 2006), available at <http://www.nyse.com/pdfs/05-045.pdf>.

68. See *Deephaven Risk Arb Trading Ltd. v. UnitedGlobalCom, Inc.*, No. Civ.A. 379-N, 2005 WL 1713067, at \*6-7 (Del. Ch. July 13, 2005) (unpublished opinion).

69. See *Parfi Holding AB v. Mirror Image Internet, Inc.*, 954 A.2d 911, 937-42 (Del. Ch. 2008).

70. See REVISED MODEL BUS. CORP. ACT § 10.20 (1984); *Int'l Bhd. of Teamsters Gen. Fund v. Fleming Inc.*, 975 P.2d 907, 912 (Okla. 1999) (discussing shareholders' role in implementing shareholder rights plans).

71. See DEL. CODE ANN. tit. 8, § 109(a) (2008).

72. See *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 230 (Del. 2008).

## III. THE DRIVE FOR SHAREHOLDER NOMINATIONS

A. *The SEC's Proxy Rules*

Corporate voting rights are generally fixed by a corporation's charter, and the nature and extent of shareholder voting rights, as well as the mechanics of holding annual meetings to elect directors, are generally specified by state law. Yet, because shareholders in public companies are geographically dispersed, proxy voting is the dominant mode of shareholder decision-making, and the solicitation of proxies by public companies is regulated by the SEC. Section 14(a) of the Exchange Act<sup>73</sup> makes it unlawful for any person to solicit any proxy, consent, or authorization with respect to any security registered under Section 12 of the Exchange Act<sup>74</sup> in contravention of the SEC's proxy rules.<sup>75</sup> The SEC's authority is not limited to ensuring full disclosure because the purpose of the proxy rules is to make the proxy device the closest practicable substitute for attendance at the meeting. Full disclosure assures that exercise of the corporate franchise will be informed but the mechanics of proxy solicitations also are regulated.

No solicitation subject to the SEC's proxy rules may be made unless each person solicited is furnished concurrently or previously with a written proxy containing the information specified in the proxy rules.<sup>76</sup> Very importantly, a proxy cannot be solicited by a company unless the certified financial statements for the prior fiscal year are included in the solicitation.<sup>77</sup> However, there is no required form for the solicitation. The proxy must indicate in bold type whether it is submitted on behalf of the company's board of directors.<sup>78</sup> Also, the proxy may not be undated and the proxy must identify clearly and impartially each matter or group of matters to be acted upon, and permit security holders to choose between approval and disapproval of each matter or group of related matters. Rule 14a-9 under the Exchange Act<sup>79</sup> is a general anti-fraud provision covering

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73. 15 U.S.C. § 78n(a) (2006).

74. *Id.* § 78l; 17 C.F.R. § 240.12g-1 (2009). Any securities sold in a registered offering, any exchange listed security, and any securities of a corporation with 500 shareholders and \$10 million in assets is such a registered and reporting company. 15 U.S.C. § 78l; 17 C.F.R. § 240.12g-1.

75. *See* 17 C.F.R. §§ 240.14a-3 to -17 (containing SEC proxy regulations covering solicitation of proxies).

76. *See* SEC Schedule 14A, 17 C.F.R. § 240.14a-101 (containing twenty-two items relating to revocability of proxy, dissenters appraisal rights, matters to be voted upon, management compensation, and financial affairs of corporation).

77. *See id.*

78. *See id.* § 240.14a-4. The proxy sent by a corporation to its shareholders is often referred to as the "management's proxy," but the nominees for the board is proposed by the sitting board of directors. I believe that referring to this proxy as the company's or corporation's proxy is legally more correct and also more neutral with regard to the battles between shareholders and boards described in this Article.

79. *Id.* § 240.14a-9.

proxy solicitations and the Supreme Court has implied a private right of action for violations of this rule.<sup>80</sup>

Another right provided to shareholders under the federal proxy rules is the right to make shareholder proposals that are required to be included in a company's proxy solicitation as long as the proponent meets all of the requirements of Rule 14a-8.<sup>81</sup> The SEC's rule sets forth a number of circumstances that permit a registrant to exclude a proposal, including: (1) the proposal is not a proper subject for action by security holders; (2) the proposal relates to the redress of a personal claim or grievance; (3) the proposal is not significantly related to the registrant's business; (4) the proposal relates to the conduct of ordinary business operations; and (5) very importantly with regard to the issues discussed in this Article, the proposal relates to an election to office.<sup>82</sup> The SEC specifies conduct of proxy contests, where proxies in opposition to the company's proxy are solicited, but the costs for such a proxy solicitation are not then paid by the corporation.<sup>83</sup>

### B. *The Proxy Access Debate*

For many years, institutional investors have been frustrated by their inability to utilize company proxies as a platform to campaign against the corporation's nominees for directors or to promote opposition nominees, and they have lobbied the SEC to change the proxy rules so that they might wage such campaigns. As far back as 1977, the SEC had Corporate Governance Hearings and, among many other questions, requested comment on whether shareholders should have access to corporations' proxy soliciting materials for the purpose of nominating persons of their choice to serve on boards.<sup>84</sup> Instead of proposing such a rule, the SEC adopted a disclosure requirement. This requirement compels companies to state whether they have a nominating committee and, if so, whether the nomi-

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80. See *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1086-87 (1991); *J.I. Case Co. v. Borak*, 377 U.S. 426, 430-32 (1964).

81. See 17 C.F.R. § 240.14a-8. Among other things, the proponent must own either 1% or \$2,000 in market value of securities entitled to vote; a proposal must be received at the company's offices not less than 120 days before the shareholder meeting; only one proposal per proponent is permitted; and the proposal and any supporting statement cannot exceed 500 words.

82. See *id.* If the registrant wishes to exclude a proposal, it must file the proposal, the supporting statement, and a statement of reasons for omitting the proposal with the SEC not later than 80 days before the date definitive proxy material is to be mailed. The SEC staff then essentially acts as a referee on the question of the proposal's inclusion.

83. See *id.* §§ 240.14a-4, -12.

84. See SEC Request for Written Statements and Announcement of Hearings: Re-examination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 13,482, 12 SEC Docket 267 (Apr. 28, 1977).

nating committee will consider shareholder recommendations.<sup>85</sup> More recently, as a result of the Sarbanes-Oxley Act of 2002, the stock exchanges amended their listing requirements so that the members of nominating committees must be independent directors.<sup>86</sup>

In 1992, some large institutional holders requested review of the proxy rules. At the heart of their proposal was the idea that institutional investors should be able to communicate freely outside the proxy rules. Among the grievances of some activist institutional investors were management resistance to giving shareholder lists, management methods for vote counting, and delays and inconsistencies in SEC staff reviews.<sup>87</sup> The SEC then amended the proxy rules, making changes that enabled shareholders who did not seek to obtain proxy authority to communicate freely, subject only to a notice filing. Rule 14a-2(b)(1) created a safe harbor, excluding from the definition of "solicitation" communications between shareholders not seeking proxy voting authority.<sup>88</sup> Another amendment enabled shareholders seeking minority board representation to fill out a partial or short slate with management nominees.<sup>89</sup> Although the shareholder still must disseminate and file a separate proxy statement and proxy card, he or she can, in essence, allow shareholders to vote for some of management's nominees on the shareholder's proxy card. But this "short slate" mechanism failed to catch on or become a useful tool.

The next significant development regarding institutional investor proxy access was a SEC staff report released in the summer of 2003.<sup>90</sup> The staff made a variety of proposals for increasing shareholder involvement in the nomination and election of directors, including: requiring companies to include shareholder nominees in company proxy materials; requiring companies to deliver nominating shareholder proxy cards along with company proxy materials; requiring expanded disclosure regarding companies' nominating committees, the nominating process, and nominating committee consideration of shareholder recommendations; requiring expanded disclosure regarding shareholder communications with board members; and revising Exchange Act Rule 14a-8 to allow shareholder proposals relating to a company's nominating process. The staff admitted there was a question as to its authority to mandate some of these changes

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85. See SEC Schedule 14A, Item 7, 17 C.F.R. § 240.14a-101; *see also id.* § 229.407.

86. See, e.g., NYSE, INC., LISTED COMPANY MANUAL § 303A.04 (2004).

87. See SEC Final Rule: Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, 57 Fed. Reg. 48,276 (Oct. 16, 1992) (codified at 17 C.F.R. pts. 240, 249).

88. 17 C.F.R. § 240.14a-2(b)(1).

89. See *id.* § 240.14a-4(d).

90. See *generally* Review of the Proxy Process Regarding the Nomination and Election of Directors, [2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,938 (July 15, 2003) (summarizing prior SEC actions and suggesting improvements to increase shareholder participation in proxy process).

because, although the SEC has some authority under the proxy rules to go beyond disclosure, its authority is not unlimited.<sup>91</sup>

Following this staff report, the SEC proposed a controversial rule (which technically remains a pending proposal) to provide shareholders with proxy access.<sup>92</sup> The rule would create a mechanism whereby director nominees of long-term security holders, with significant holdings, could be included in company proxy materials where there are indications that the proxy process has been ineffective or that security holders are dissatisfied with that process. The names of shareholder nominees proposed through this mechanism could be submitted by a shareholder or group who has beneficially owned at least five percent of shares outstanding for at least two years and who also expresses the intent to hold the shares through the annual meeting.<sup>93</sup> Two circumstances would trigger shareholder access: (1) the receipt of more than thirty-five percent “withhold” votes for any director, or (2) a shareholder proposal to activate the shareholder access process proposed by a shareholder or group who have held at least one percent of outstanding shares for one year and received a majority of shareholder votes cast.

The proposed rule placed limits on the maximum number of nominees that shareholders might propose.<sup>94</sup> Under the proposed rule, the candidacy or election of board nominees also would not be allowed to violate controlling state law, federal law, or the rules of any applicable national securities exchange or association. Further, the nominee would have to satisfy the objective independence criteria of the listing standard applicable to the issuer and have no specified relationships with the nominating shareholder or group or agreements with the issuer regarding the nomination. This proposed rule did not address the issue of empty voting

91. *See id.* at 12.

92. *See* SEC Proposed Rule: Security Holder Director Nominations, Exchange Act Release No. 48,626, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274).

93. *See id.* at 60,794. The proposed rule provided:

To be eligible to submit a nomination in accordance with proposed Exchange Act Rule 14a-11, a security holder or group of security holders would be required to: [b]eneficially own, either individually or in the aggregate, more than 5% of the company's securities that are eligible to vote for the election of directors at the next annual meeting of security holders (or, in lieu of such an annual meeting, a special meeting of security holders), with each of the securities used for purposes of calculating that ownership having been held continuously for at least two years as of the date of the nomination; [i]ntend to continue to own those securities through the date of that annual or special meeting.

*Id.*

94. *See id.* at 60,797. These limits were: one nominee if the board has eight or fewer directors; two nominees if the board has between nine and nineteen directors; and three nominees if the board has twenty or more directors. If a company were to receive nominees in excess of the applicable numbers, those nominees from a shareholder or group with the largest share ownership would be selected as nominees.



or hidden voting, but it was predicated on the idea that only a long-term, substantial shareholder should be permitted to nominate a director in opposition to the company's slate by using the corporation's proxy.

Because the SEC did not move forward with its proxy access rule proposal, institutional shareholders turned to other mechanisms to try to achieve the result they desired. Specifically, efforts were made to use shareholder proposals to amend corporate by-laws to permit shareholders to use the company's proxy for their nominees. In administering Rule 14a-8(i)(8), however, the SEC staff had taken the position that with respect to corporate elections, that rule is not the proper means for conducting campaigns or effecting reforms in elections of that nature, as other proxy rules, including Rule 14a-12, are applicable.

This interpretation was challenged in *American Federation of State, County & Municipal Employees v. American International Group, Inc.*<sup>95</sup> There, a shareholder proposal sought to amend the corporate by-laws to establish a procedure by which shareholder-nominated candidates could be included on the corporate ballot. The issue was whether the exclusion under the SEC proxy rules pertained to a particular contested election or a future contested election. The Second Circuit held that the shareholder proposal did not relate to an election within the meaning of the Rule 14a-8(i)(8) and, therefore, could not be excluded from corporate proxy materials under that regulation. It further held that the language of the SEC's rule, and its past and present interpretations of the rule, were ambiguous. Claiming to be taking no side in the policy debate regarding shareholder access to the corporate ballot, the Second Circuit nevertheless gave the plaintiff union the right to include on AIG's proxy solicitation a proposal to change the company's by-laws to allow election contests between the directors' nominees and shareholder's nominees. This holding was contrary to the SEC staff's view, as expressed in no-action letters and its letter to the court (in lieu of a formal amicus brief) in this case. The basis for the Second Circuit's decision was that the SEC had not justified a changed interpretation of its own rules between 1976 and 1990.

Thus, the Second Circuit invalidated the SEC's interpretation of Rule 14a-8(i)(8) and challenged the SEC to reinterpret the election exclusion or pass a new rule. In response, the SEC confirmed its position that shareholder proposals that could result in an election contest may be excluded under Rule 14a-8(i)(8), but sought comment as to whether the text of the rule should be changed. The SEC pointed out that its 2003 rule proposal to govern shareholder director nominations that are not control-related would not have been made if Rule 14a-8(i)(8) could be used in contested elections. The Commission stated:

a proposal may be excluded under Rule 14a-8(i)(8) if it would result in an immediate election contest . . . or would set up a

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95. 462 F.3d 121 (2d Cir. 2006).

process for shareholders to conduct an election contest in the future by requiring the company to include shareholders' director nominees in the company's proxy materials for subsequent meetings.<sup>96</sup>

Yet the SEC proposed changes to the language in Rule 14a-8(i)(8), so that the election exclusion would read: "If the proposal relates to a nomination or an election for membership on the company's board of directors . . . or a procedure for such nomination or election."<sup>97</sup>

On the same day as the foregoing proposal, the SEC alternatively proposed an amendment to Rule 14a-8 that would permit the inclusion of shareholder-proposed by-law changes in companies' proxy materials. These by-law changes could relate to procedures for nominating candidates to the board of directors if the shareholder or group making the proposal held at least five percent of the company's outstanding shares for at least one year.<sup>98</sup> The SEC further proposed Rule 14a-17, which would allow the same shareholders to place shareholder proposed nominees on a company's proxy.<sup>99</sup> Under this proposed rule, the SEC would require new and additional disclosures about the proponents in SEC filings, including any contract with the company (such as a collective bargaining contract), any pending or threatened litigation against the company, or any material relationship between the shareholder proponent and the company.<sup>100</sup> These proposals were more deferential to state law regarding corporate governance than the SEC's prior rule proposal, and asked a number of questions concerning the appropriateness of the five percent, one-year stockholder screening test.

These releases were both put out by a 3-2 vote, with Chairman Christopher Cox voting with the two Democratic commissioners on the Rule 14a-17 proposal and with the two Republican commissioners with regard to the interpretative release on Rule 14a-8. The releases were preceded by three roundtables. Some participants argued that the federal role should facilitate shareholders' exercise of their fundamental state law and company ownership rights to elect the board of directors. The SEC concluded that although the federal proxy rules can be better aligned with shareholders' rights to nominate and elect directors, the vindication of these state law rights must be accompanied by full and fair disclosure.<sup>101</sup>

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96. SEC Proposed Rule: Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56,161, 72 Fed. Reg. 43,488, 43,492 (proposed Aug. 3, 2007) (to be codified at 17 C.F.R. pt. 240) [hereinafter Interpretation and Proposed Rule]; SEC Proposed Rule: Shareholder Proposal, Exchange Act Release No. 56,160, 72 Fed. Reg. 43,466 (proposed Aug. 3, 2007) (to be codified at 17 C.F.R. pt. 240) [hereinafter Shareholder Proposals].

97. Interpretation and Proposed Rule, *supra* note 96, at 43,493.

98. See Shareholder Proposals, *supra* note 96, at 43,469.

99. See *id.* at 43,475.

100. See *id.* at 43,473, 43,486-88.

101. See *id.* at 43,469.

After Mary Schapiro became Chairman of the SEC, the SEC once again put forward a proxy access proposal to add Rule 14a-11.<sup>102</sup> Under this proposal, companies must disclose the nominee or nominees of any shareholder or group that meets the rule's eligibility standards as to a minimum amount of securities beneficially owned for at least one year. These ownership requirements would vary with the size of the issuer.<sup>103</sup> To strengthen the protection against a change of control, proposed Rule 14a-11 limits the number of allowed shareholder nominees to one director or twenty-five percent of the size of the board, whichever is greater.<sup>104</sup> As a result of this limitation, the proposed rule takes a first-come, first-served approach when the number of shareholder nominees exceeds the limit.<sup>105</sup> Further, there must be no relationship between the shareholder nominee or the nominator and the company, although the proposed rule does not prohibit a relationship between the nominator and the nominee.<sup>106</sup>

The proposed rule also imposed new limitations on nominators. The nominator would have to represent that it intends to own the required securities through the date of the annual meeting.<sup>107</sup> The nominator also must not have acquired these stocks with an intention to change company control.<sup>108</sup> A new disclosure form, Schedule 14N, would be required, and increased disclosure requirements for nominees would be imposed on company-nominated and shareholder-nominated directors.<sup>109</sup>

The SEC's 2009 proposal also includes a reformulation of Rule 14a-8(i)(8), which would allow proposals that would amend a company's governing documents regarding nomination procedures, provided the proposal does not conflict with Rule 14a-11 or state law.<sup>110</sup> Shareholders who wish to make such a proposal under Rule 14a-8(i)(8) are subject to the one percent stock ownership and two-year holding period requirements of Rule 14a-8.<sup>111</sup> Shareholder proposals also could not disqualify a nominee who is standing for election or remove a director from office before the

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102. See Facilitating Shareholder Director Nominations, *supra* note 2.

103. See *id.* at 29,035. For large accelerated filers with net assets of \$700 million or more, the shareholder or shareholder group nominating candidates would have to own at least 1% of the company's voting securities; for accelerated filers with net assets of \$75 million or more, but less than \$700 million, there would be a 3% ownership requirement; and for non-accelerated filers with net assets of less than \$75 million, there would be a 5% ownership requirement. See *id.*

104. See *id.* at 29,043.

105. See *id.* at 29,044.

106. See *id.* at 29,041.

107. See *id.* at 29,035.

108. See *id.* at 29,037.

109. See *id.* at 29,037-38.

110. See *id.* at 29,056.

111. See *id.*

expiration of his or her term, or question the competence, business judgment or character of one or more nominees or directors.<sup>112</sup>

### C. *Majority Voting*

In the 1990s, institutional shareholders embarked upon “just vote no” campaigns, whereby investors campaigned to have unsatisfactory directors removed by shareholder abstentions on their candidacies. But due to plurality voting laws in most states, these campaigns did not necessarily succeed in removing objectionable directors from corporate boards. Under a plurality voting regime, as exists in Delaware and other states, a candidate for director needs to obtain a greater number of the votes cast than any other candidate, even if he or she does not receive an outright majority. Therefore, even if a majority of the shareholders abstain from voting for a particular director, the director may be elected to serve another term. Changes to this plurality voting regime must accompany any majority voting rule.

Having been rebuffed in their efforts to gain access to management’s proxy, or to remove directors from boards, shareholder activists began making shareholder proposals to the effect that any director not receiving a majority of shareholder votes (in some cases a majority of outstanding shares, and in other cases a majority of votes cast) would not be elected. A primary argument for this principle is that it would be more democratic than having shareholders vote for a slate of directors proposed by the company. Corporate board elections were criticized as “Soviet-style” elections. On the other hand, should corporations and shareholders emulate U.S.-style political elections? It was also argued that because shareholders are the owners of the corporation they should have an opportunity to propose their own directors and rid the board of unsatisfactory directors.<sup>113</sup> Although shareholders can vote for board members, there are structural impediments to electoral challenges and so few director elections are contested. Further, although shareholders can abstain from voting for a director, the plurality voting principle of state law allows a director who does not receive a majority of votes to remain in office. Accordingly, reformers argue that the only way to depose non-performing directors and hold a board accountable to its shareholders is to provide for majority voting.

The primary argument against majority voting is that such a regime can result in a failed election where the board might be left with one or several vacancies and, in addition, might no longer have a sufficient number of independent directors to comply with the Sarbanes-Oxley Act. But

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112. *See id.* at 29,058.

113. The mantra that shareholders are “owners” of the corporation is nice rhetoric, but has a number of theoretical and legal problems. *See* Karmel, *supra* note 9, at 1-2; Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1189-1201 (2002); *see also* Jennifer Hill, *Visions and Revisions of the Shareholder*, 48 AM. J. COMP. L. 39, 42-47, 58 (2000).

it is a matter of general state law that an incumbent director can serve until a successor is appointed. Also, the board generally can fill any vacancies on the board until the next election of directors.

In any event, institutional shareholders, and union pension funds in particular, have been quite successful in persuading public corporations to adopt majority voting by-laws. The two principal majority voting models that companies have implemented have been the Pfizer approach<sup>114</sup> and the Intel approach.<sup>115</sup> Since its inception, the majority voting movement

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114. See FOLEY & LARDNER, LLP, MAJORITY VOTING UPDATE, SHAREHOLDER DEMOCRACY, AND HOW BOARD SHOULD RESPOND TO HEDGE FUNDS AND SHAREHOLDER ACTIVISTS 2 (2007) [hereinafter MAJORITY VOTING UPDATE], available at [http://www.foley.com/files/tbl\\_s31Publications%5CFileUpload137%5C4180%5CMajorityVotingUpdate.pdf](http://www.foley.com/files/tbl_s31Publications%5CFileUpload137%5C4180%5CMajorityVotingUpdate.pdf). Notably,

[u]nder the Pfizer approach, a corporate governance policy provides that a director who receives more votes withheld than in favor of his or her election (i.e., if a majority of votes are withheld) is required to submit his or her resignation to the board, although such director is still technically elected. If this happens, then the company's corporate governance or similar committee will consider, but is not required to accept, such resignation.

*Id.* A Pfizer-style proxy card has two voting options: "for" and "withhold." The policy generally does not apply to contested elections. The policy provides that:

- (1) The Pfizer board will act on a director's offer to resign within 90 days of the certification of the stockholder vote at issue;
- (2) The board will promptly disclose through a press release its decision to accept the resignation offer or, if applicable, the reason(s) for rejecting the offer;
- (3) The "majority withheld" voting policy will be limited to uncontested director elections; and
- (4) Any director who tenders his or her resignation will not participate in any consideration by the board of the resignation offer.

STOEL RIVES CORPORATE COUNSEL ROUNDTABLE DISCUSSION SERIES, MAJORITY VOTING FOR DIRECTORS: IS IT TIME? MAJORITY VOTING AT PFIZER, NIKE, INTEL AND PROGRESS ENERGY 2-3 (2006) [hereinafter MAJORITY VOTING FOR DIRECTORS], available at <http://www.stoel.com/webfiles/CorpCounselRoundtablePfizer-Nike-Intel-Progress%20Energy.pdf>.

115. See MAJORITY VOTING UPDATE, *supra* note 114, at 2-3. Notably, [t]he Intel approach takes the form of a by-law amendment that requires that, in uncontested elections, a director must receive a majority of the votes cast to be elected. Contested elections will continue to use the plurality vote standard. If the director does not receive a majority of the votes cast, then he or she is not elected. But, under the laws of many states, any such director who is an incumbent would still continue in his or her position under holdover rules because a successor to the director has not been elected. However, a director who is not elected must offer his or her resignation to the board. An Intel-style proxy card has three voting options: "for," "against," and "abstain." To the advocates of this approach, the fact that majority voting is required by the company's by-laws, and not merely by corporate governance principles, provides a more permanent and formal means of ensuring majority voting.

*Id.* Pursuant to the Intel policy, if an incumbent director is not elected by a majority and must offer his or her resignation to the Intel board, the board's corporate governance and nominating committee would then make a recommendation to the board on whether to accept or reject the resignation, or take other action.

has gained considerable traction. By August 2007, over sixty percent of S&P 500 companies had adopted some type of election reform.<sup>116</sup> In 2008, the number of S&P 500 companies that had adopted majority voting increased to more than seventy-three percent.<sup>117</sup>

In order to accommodate majority voting by-law changes, states have amended their laws with regard to plurality voting standards. Recently, the Committee on Corporate Laws of the Section of Business Law of the American Bar Association (the ABA Committee) adopted amendments to the Model Act that facilitate majority voting in director elections.<sup>118</sup> The ABA Committee recognized the widespread impact that would result from a wholesale change from the current plurality voting default rules. The Committee thus chose to leave the plurality voting rules intact, focusing instead on facilitating individual corporate action by permitting the adoption of by-laws mandating majority voting.

Through the adoption of these by-law amendments, publicly held companies could apply a specified plurality voting system for the election of directors, unless the company's charter already provided for cumulative voting in the election of directors, provided for director election by other means, or specifically prohibited the adoption of such a system.<sup>119</sup> While these amendments do not impose any mandatory requirements on public companies, they do provide additional momentum for the trend towards majority voting. The Model Act is the foundation of corporate statutes in many jurisdictions, but not in Delaware.

The Delaware legislature recently adopted amendments to the Delaware General Corporation Law (DGCL) that facilitate majority voting in

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Further, the board would then publicly disclose its decision and the rationale behind it within ninety days of the certification of the election results. *Id.* at 7-8.

116. See CLAUDIA ALLEN, STUDY OF MAJORITY VOTING IN DIRECTOR ELECTIONS 1 (2007), available at <http://www.ngelaw.com/files/upload/majoritystudy111207.pdf>.

117. See GEORGESON, 2008 ANNUAL CORPORATE GOVERNANCE REVIEW 6 (2008).

118. See REVISED MODEL BUS. CORP. ACT § 7.28 (1984) (amended 2006); AKIN GUMP STRAUSS HAUER & FELD LLP, SECURITIES ALERT: RECENT LEGISLATIVE CHANGES PROVIDE MOMENTUM FOR MAJORITY VOTING MOVEMENT 2 (2006), <http://www.akingump.com/files/Publication/46958a12-4d6c-4bf2-9743-65a5cbee9de8/Presentation/PublicationAttachment/3e8f7b8c-7615-48d3-a395-68064af11e3b/897.pdf>.

119. See REVISED MODEL BUS. CORP. ACT § 10.22. The amendments to the Model Act continue to provide for election by a plurality vote, but with the qualification that a nominee who is so elected but fails to receive a majority of the votes cast in the director's election would serve as a director only for a term ending on the earlier of: (1) ninety days from the date on which the voting results are determined; or (2) the date on which an individual is selected by the board to fill the office held by such director, which selection would be deemed to constitute the filling of the vacancy by the board. The ABA Committee also adopted procedures by which corporations could repeal the by-law provisions of the Model Act. If originally adopted by stockholders, the by-law provisions could be repealed only by stockholders, unless the by-law provides otherwise. If adopted by the board, the by-law provisions of the Model Act could be repealed by the board or the stockholders.

the election of directors. Among other changes, the amendments to the DGCL provide that a resignation may be made effective upon the occurrence of a future event or events, coupled with authority granted in the same section to make certain resignations irrevocable (i.e., a corporation is permitted to enforce a director's resignation conditioned upon the failure of the director to achieve a specified vote for re-election).<sup>120</sup> This amendment also addresses the potential fiduciary duty issue surrounding director resignations by allowing a director to agree to resign prior to the occurrence of a specific event (e.g., failure to receive a majority vote).

An additional amendment to the DGCL provides that a by-law adopted by stockholder vote that prescribes the required vote for the election of directors may not be altered or repealed by the board.<sup>121</sup> When coupled with board acceptance of a director resignation, these provisions permit corporations and individual directors to agree voluntarily to voting standards for the election of directors that differ from the DGCL plurality default standard. These recent amendments to the DGCL thus increase the momentum of the majority voting movement.

#### D. *Reimbursement for Proxy Contest Expenses*

Generally, a dissident shareholder is required to pay his or her own expenses in a proxy contest. If the dissident is successful, the corporation might decide that proxy contest expenses can be reimbursed. The standards for this determination are, at best, hazy, but generally the rule is that reimbursement for proxy contest expenses can be paid if the contest is with regard to matters of policy, not personnel.<sup>122</sup> Further, this principle applies to successful insurgents as well as incumbent directors.<sup>123</sup> An interesting recent shareholder proposal by AFSCME Employees Pension Plan with regard to such reimbursement resulted in an important Delaware Supreme Court decision about the authority of shareholders to amend by-laws.<sup>124</sup> In *CA, Inc. v. AFSCME Employees Pension Plan*,<sup>125</sup> AFSCME submitted a proposed by-law for inclusion in the proxy statement of CA, Inc. (CA) that would require the board of directors to cause the corporation to reimburse a stockholder or stockholder group (the Nominator) for reasonable expenses incurred in a contested election of directors, including without limitation, expenses for printing, mailing, le-

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120. See DEL. CODE. ANN. tit. 8, § 141(b) (2009).

121. See *id.* § 216.

122. See *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 344 (Del. 1983) (holding that incumbent directors may use corporate funds to defend proxy contests if the contest is about policy issues and expenses are reasonable); *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 171 A. 226, 227-28 (Del. Ch. 1934); see also *Selama-Dindings Plantations, Ltd. v. Durham*, 216 F. Supp. 104, 114-15 (S.D. Ohio 1963).

123. See, e.g., *Johnson v. Tago*, 233 Cal. Rptr. 503, 506 (Cal. Ct. App. 1986); *Rosenfeld v. Fairchild Engine and Airplane Co.*, 128 N.E.2d 291, 293 (N.Y. 1955).

124. See *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008).

125. 953 A.2d 227 (Del. 2008).

gal, solicitation, travel, advertising, and public relations, so long as: (a) the election of fewer than fifty percent of the directors to be elected is contested; (b) one or more of candidates nominated by the Nominator are elected to the board; (c) stockholders are not permitted to cumulate their votes; and (d) the election occurred, and the expenses were incurred, after the by-law is adopted.<sup>126</sup> The proposed by-law also provided that the amount paid to a Nominator shall not exceed the amount expended by the corporation in the contested election.<sup>127</sup>

CA objected to the inclusion of this proposal on the grounds that it was not a proper subject for shareholder action, and if implemented, would violate the DGCL.<sup>128</sup> The proponent submitted an opinion letter to the contrary. Faced with this conflict regarding Delaware law, the SEC took advantage of a recently adopted procedure allowing the SEC staff to refer questions of Delaware law to the Delaware Supreme Court.<sup>129</sup> The SEC certified two questions regarding this proposal: Was the by-law a proper subject for shareholder action, and would it violate the DGCL? The court held that the shareholders' power to adopt by-laws is limited by the management's prerogatives and responsibilities. It drew a distinction between by-laws that define the process and procedures by which business decisions are made (the proper function of by-laws), and by-laws that purport to mandate specific substantive business decisions (which are improper). The court held that the subject matter of the proposed by-law was proper, even though it would have required an expenditure of corporate funds, because it would facilitate the shareholders' right to participate in selecting candidates for election to the board, since the by-law was related to a "legitimate and protected interest."<sup>130</sup> But the court also held that the by-law would violate Delaware law because the directors would be committed to a course of action "that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders."<sup>131</sup> In other words, such a by-law with a "fiduciary out" would be lawful.

The language of the court in CA suggests that Delaware might allow a shareholder to amend a corporation's by-laws to allow for shareholder nominees on the company ballot, but this is far from clear. In an old Delaware case, *Empire Southern Gas Co. v. Gray*,<sup>132</sup> the court enjoined a corporation from sending out proxy material on behalf of the corporation

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126. *Id.* at 230.

127. *Id.*

128. *Id.*

129. See DEL. CONST. art. IV, § 11(1)(c)(8).

130. CA, Inc., 953 A.2d at 237.

131. *Id.* at 238.

132. 46 A.2d 741 (Del. Ch. 1946). Similarly, in *Gould v. American Hawaiian Steamship Co.*, the court stated that "under Delaware law, the Board of Directors comprised the management of the corporation, and was the sole body empowered to make proxy solicitations on behalf of the management." 351 F. Supp. 853, 858 (D. Del. 1972).



where nominees were not supported by the board. The Court's decision rested on the finding that only incumbent directors were entitled to speak for the corporation. Nevertheless, after *CA*, if a shareholder proposal reserved a "fiduciary out" to directors, it would seem that under Delaware law a shareholder could propose a by-law allowing competing nominees on the corporation's proxy.

#### E. *Recent Delaware Legislation*

Recent legislation in Delaware would clarify these matters. This legislation would permit by-law amendments providing for stockholder-nominated candidates to appear on the same ballot as the corporation's proxy solicitation. Further, procedures or conditions for such a nomination by shareholders could require a minimum record or beneficial ownership, or duration of ownership by the nominating shareholder, and define beneficial ownership to include options or other rights in respect of or related to stock. Other permitted conditions could prohibit nominations by a stockholder who acquired or proposed to acquire shares constituting a specified percentage of the voting power of the corporation's stock within a specified period before the election of directors.<sup>133</sup>

This legislation also would allow by-law amendments that provide for reimbursement by the corporation of expenses incurred by a shareholder proxy solicitation in connection with an election of directors, subject to certain procedures or conditions. These conditions could include predicated the eligibility for reimbursement upon the number or proportion of persons nominated, and upon the proportion of votes cast in favor of a shareholder nominee.<sup>134</sup>

This legislation could be an important predicate for a better SEC shareholder access rule than the one currently under consideration by the SEC. If the SEC were simply to amend Rule 14a-8(i)(8) to allow by-law changes permitting or mandating competing shareholder and company nominations, private ordering and experimentation under state law could lead to a development of various methods for election contests. Instead, the SEC's proposed Rule 14a-11 is a rigid command and control regime that essentially preempts state law.

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133. See An Act To Amend Title 8 of the Delaware Code Relating to the General Corporation Law, H.R. 19, 145th Gen. Assem. (Del. 2009) (adding § 112 to DEL. CODE, tit. 8).

134. See *id.* (amending § 113, DEL. CODE, tit. 8). This law also would permit separate record dates for determining stockholders entitled to notice of and to vote at a meeting in order to better align voting shares with beneficial owners on the date of the annual meeting. See *id.* (amending § 222, DEL. CODE, tit. 8).

## IV. THE SEC'S FAILURE TO ADDRESS EMPTY AND HIDDEN VOTING

A. *Empty Voting and SEC Reporting Requirements*

There are a variety of Forms requiring large share owners to report their holdings. These reporting requirements are generally designed to alert the market to possible changes in control of public companies or to transactions by public company insiders. Accordingly, these requirements generally define share ownership expansively. On the other hand, the SEC has not been overly concerned about hidden voting.<sup>135</sup> Section 13(d) of the Exchange Act requires any person who directly or indirectly acquires the beneficial ownership of five percent of the securities of any registered and reporting company to file a report of such acquisition with the SEC and the issuer of such securities within ten days of the acquisition.<sup>136</sup> This requirement applies to

any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) voting power which includes the power to vote, or to direct the voting of, such security; and/or, (2) investment power which includes the power to dispose, or to direct the disposition of, such security.<sup>137</sup>

The SEC has promulgated Forms 13D for active five percent shareholders to implement this provision.<sup>138</sup>

Section 13(h)<sup>139</sup> provides a filing requirement for "large traders," and the SEC has promulgated Form 13G for such passive investors who do not intend to influence control.<sup>140</sup> Then Form 13F has been promulgated for institutional investors holding over \$100 million of Section 13(f) securities.<sup>141</sup> These forms are geared to "beneficial ownership," broadly defined, which includes the right to acquire beneficial ownership within sixty days through the exercise of warrants or options. There is not much clarity on how stock borrowing and lending is treated.<sup>142</sup> Recently, Goldman Sachs & Co. obtained a no-action letter permitting the firm to net certain

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135. See *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008). But see Jenny Strasburg, *SEC Halts a Strategy On Merger Disclosures*, WALL ST. J., July 22, 2009, at C1.

136. 15 U.S.C. § 78m(d) (2006). Large traders fall into a different category but nevertheless need to report their transactions.

137. 17 C.F.R. § 240.13d-3 (2009); see also SEC Final Rule: Adoption of Beneficial Ownership Disclosure Requirements, Exchange Act Release No. 13,291, 42 Fed. Reg. 12,342 (Mar. 3, 1977).

138. See 17 C.F.R. § 240.13d-101.

139. 15 U.S.C. § 78m(h).

140. See 17 C.F.R. § 240.13d-102.

141. See *id.* § 240.13f-1.

142. See Hu & Black, *supra* note 56, at 1041.

long and short positions in its Forms 13D and 13G for internal positions in its stock record, and for which it lacks voting and dispositive rights.<sup>143</sup>

Professors Hu and Black have suggested that SEC disclosure requirements for Forms 13D, F, and G should be revised in order to flush out empty and hidden voting, especially because financial futures derivatives are not considered securities.<sup>144</sup> Similar problems exist, and similar recommendations for better disclosure have been made, with regard to reporting of insider purchases and sales based on economic ownership pursuant to Section 16(a) of the Exchange Act.<sup>145</sup> Nevertheless, the definition of "beneficial owner" for purposes of Section 16(a) reporting by officers, directors, and ten percent stockholders appears to be broader than Section 13(d) reporting in that it covers a person's right to acquire equity securities through the exercise of any derivative security, and derivative security means any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or with a value derived from the value of an equity security.<sup>146</sup>

The problems with reporting (and non-reporting) of holdings offsetting long positions will reappear with the SEC's shareholder access rules. This is because the eligibility of shareholders nominating directors to use Schedule 13G would not change. The SEC has taken the position that such shareholders are not required to file a Schedule 13D because they are not seeking to change or influence control of the issuer. This formulation is not justified. Of course, shareholders engaged in a proxy contest are seeking to influence control of the issuer, and if their candidate or candidates win, they will have succeeded in doing so.<sup>147</sup>

#### B. *The Continuous Ownership Requirement*

Under proposed Rule 14a-11, to be eligible to submit a proposal, a shareholder must have continuously held a prescribed percentage of the company's securities entitled to be voted on the proposal at the meeting for at least one year prior to the date of submission, and continue to hold such securities through the date of the meeting. Further, if the shareholder making the nomination is not the record owner, a written statement is required from the record holder that the shares have been held by

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143. See Goldman Sachs & Co., SEC No-Action Letter, 2008 WL 5484332, at \*1, \*4-6 (Dec. 30, 2008).

144. See Hu & Black, *supra* note 56, at 1041-45, 1047-55.

145. See *id.* at 1045-46.

146. See 17 C.F.R. § 240.16a-1.

147. See Letter from Jeffrey W. Rubin, Chair, Comm. on Fed. Regulation of Sec., Am. Bar Ass'n. Bus. Law Section, to Elizabeth Murphy, Sec'y, U.S. Sec. and Exch. Comm'n, at 55-58 (Aug. 31, 2009) [hereinafter 2009 Letter from Rubin to Murphy], available at <http://www.sec.gov/comments/s7-10-09/s71009-456.pdf>.

the nominating shareholder or group for at least one year.<sup>148</sup> Because of the manner in which institutional investors trade and hold securities, and the widespread practice by them of lending securities in order to increase their profits, issues can arise as to whether an institution has “continuously held” a large position in a security.

Such positions are usually calculated according to the stock record, but, as explained above, most holders are not holders of record or legal owners of stocks. Under Rule 14a-8, shareholder proponents who are not record holders of shares they beneficially own must provide proof of ownership in connection with a shareholder proposal, either through a written statement from the record holder of such shares (verifying that the proponent continuously held the securities for at least one year, at the time of making its proposal), through Schedules 13D, 13G, 13F, Form 4 or Form 5, or through amendments to these Forms to demonstrate ownership on or before the one-year eligibility date.

The existence of stock ownership requirements creates issues regarding the computation and proof of stock ownership, particularly when it comes to stock loans. Hospitality Properties Trust (HPT) objected to a proposal from CalPERS on the ground that CalPERS’ Form 13F filings did not reflect ownership of HPT shares for one year, in part because CalPERS and the record owner of HPT shares were unable to confirm that none of the one million dollars worth of shares of HPT stock owned by CalPERS was lent during the one year prior to the shareholder proposal. The incoming letter of objection argued that a person who loans shares, like a holder of exercisable stock options, might for purposes of Regulation 13D be a “beneficial owner” of such shares, but not a “shareholder” and not an owner or holder for purposes of Rule 14a-8.<sup>149</sup> Because share-lending transactions can lead to multiple claims of stock ownership at any one time,<sup>150</sup> which shareholder should have the right to make a shareholder nomination under the SEC’s access rule: the beneficial owner or the borrower of stock, who is generally a short seller? Is the vote a right that should be able to be bought and sold for the purpose of making shareholder nominations, or would such vote trading violate state law?

In a comment letter on the SEC’s 2003 proposal on shareholder access, the American Society of Corporate Secretaries expressed the view

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148. See Facilitating Shareholder Director Nominations, *supra* note 2, at 29,045.

149. See Letter from Margaret R. Cohen, Skadden, Arps, Slate, Meagher & Flom, LLP, to SEC Div. of Corp. Fin., at 6 (Dec. 24, 2008), available at <http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2008/calpers122408-14a8-incoming.pdf>. The SEC did not concur with Skadden’s view that HPT may exclude the proposal under Rule 14a-8. See Letter from Heather L. Maples, SEC Div. of Corp. Fin., to Margaret R. Cohen, Skadden, Arps, Slate, Meagher & Flom, LLP, at 2 (Feb. 26, 2009), available at <http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2009/calpers022609-14a8.pdf>.

150. See Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1255-63 (2008).

that requirements under Rule 14a-8 are not sufficient to ensure that a shareholder proposal has been submitted by a greater than one percent security holder and that "only beneficial owners, representing the real economic interest in the corporation, should be entitled to designate board candidates under the proposed rule. Intermediaries, custodians and other agents should be disqualified from acting without authorization from the beneficial owner."<sup>151</sup> Further, every step in such a chain of authorizations should be "transparent, fully documented and verifiable."<sup>152</sup>

The problem of director nominations by short-term shareholders is not solved by the SEC's one-year holding period under proposed Rule 14a-11 or verification by the record holder, even if the shareholder has in fact held a substantial position for a year. Previously, I proposed that any shareholder nominating a director be required to hold securities for the term of a successfully nominated director, and take on fiduciary duties similar to the duties that burden a controlling shareholder.<sup>153</sup> The SEC has asserted that a nominating shareholder or group would not be bound by the same fiduciary duties applicable to the members of a nominating committee.<sup>154</sup> This is a basic problem with the SEC's proposed proxy access rule. Why should persons with no responsibility to the corporation or other shareholders obtain the privilege of nominating directors on the same ballot as those nominated by the nominating committee? The SEC's proxy access rule would undermine the role of the independent nominating committee prescribed by the Sarbanes-Oxley Act, and poses significant issues of compliance with various statutes prescribing independent directors.<sup>155</sup>

### C. *The SEC's Authority*

Although the SEC argues in its shareholder access rules proposal that its authority under Section 14(a) of the Exchange Act goes beyond disclosure,<sup>156</sup> the power to regulate the mechanics of proxy solicitations does not give the SEC license to change or enlarge shareholder rights under state law. *Business Roundtable v. SEC* clarified that the SEC's authority under the proxy rules does not extend to altering "the distribution of pow-

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151. Letter from Susan Ellen Wolf & Pauline Candaux, Co-Chairs, Subcomm. on Dir. Nominations, Am. Soc'y of Corp. Sec'ys, to Jonathan G. Katz, Sec'y, U.S. Sec. and Exch. Comm'n, at 14 (Dec. 22, 2003), *available at* <http://www.sec.gov/rules/proposed/s71903/ascs122203.htm>.

152. *Id.*

153. See Karmel, *supra* note 9, at 13, 20-21.

154. See Facilitating Shareholder Director Nominations, *supra* note 2, at 29,047.

155. See Letter from Mary T. Afflerbach et al. to Elizabeth Murphy, Sec'y, U.S. Sec. and Exch. Comm'n, at 7 (Aug. 17, 2009), *available at* <http://www.sec.gov/comments/s7-10-09/s71009-472.pdf>.

156. For a discussion of the SEC shareholder access rules proposal, see *supra* note 92 and accompanying text.

ers among the various players in the corporate governance process.”<sup>157</sup> State corporate law generally governs the director nomination process and does not give shareholders a right of access to the corporation’s proxy. Nevertheless, such a right might be granted by a corporation’s charter or by-laws.<sup>158</sup> Therefore, if any SEC rule on proxy access were interpreted to grant shareholders rights they do not enjoy under state law, the rule would be beyond the SEC’s authority.

In 2007, the SEC tried to limit its proxy access rule proposals by providing that a shareholder proposal is not required to be included unless it is consistent with state law and the company’s charter and by-laws.<sup>159</sup> This caution has now been eliminated. Rather, the SEC’s current proxy access proposed rule would apply unless state law or a company’s governing documents prohibit shareholders from nominating directors.<sup>160</sup> Does this mean that a corporation’s charter or by-laws could deny shareholders the right to nominate directors as provided in Rule 14a-11? Or is proposed Rule 14a-11 a minimum federal standard? This is a serious question, not readily answered by the SEC’s proposed rule,<sup>161</sup> and an opt-out could help to ward off a challenge that this rule is beyond the SEC’s authority.

Another federal-state conflict issue is whether by granting the right to change by-laws or add opposing nominations to the company’s proxy solicitation only to a particular category of shareholders—one, three, or five percent holders for at least one year—the SEC is making distinctions among shareholders that are in conflict with state law. Further, if, as recommended in this Article, the SEC defines the holding period so as to require continuous economic ownership as well as continuous voting rights, is the SEC changing any state law concept of eligible shareholder voters? While I believe that the SEC should so limit its proxy access rules, this categorization is troubling. However, it is a variation of the SEC rules pursuant to which shareholders are eligible to make shareholder proposals, and Rule 14a-8 has not been challenged on this ground.

Although a number of commentators questioned the SEC’s authority to regulate shareholder access to management’s proxy, others argued that the SEC has such authority.<sup>162</sup> As a matter of policy, the SEC’s 2007 rule proposals, which make shareholder access a two-step process, requiring first a by-law, would seem to be a better approach because it is more con-

157. 905 F.2d 406, 412 (D.C. Cir. 1990).

158. See Letter from Comm. on Fed. Regulation of Sec., Am. Bar Ass’n Section of Bus. Law, to Jonathan G. Katz, Sec’y, U.S. Sec. and Exch. Comm’n, at 5 (Jan. 7, 2004), available at <http://www.sec.gov/rules/proposed/s71903/aba010704.htm>.

159. See SEC Proposed Rule: Shareholder Proposals, Securities Act Release No. 56,160, 72 Fed. Reg. 43,466, 43,471 (Aug. 3, 2007).

160. See Facilitating Shareholder Directors Nominations, *supra* note 2, at 29,031.

161. See 2009 Letter from Rubin to Murphy, *supra* note 147, at 38.

162. See Robert N. Schwartz, *A Proposal for the Designation of Shareholder Nominees for Director in the Corporate Proxy Statement*, 74 COLUM. L. REV. 1139, 1155 (1974).

sistent with state law, in particular the evolving law in Delaware. Dealing with a definition of shareholders entitled to make such proposals is a bit trickier. Addressing the problems of empty voting and non-continuous ownership would at first blush appear to be state law questions. Yet, the SEC had created this problem to some extent by reason of its regulation of "street name" voting by broker-dealers. Further, the SEC has not addressed these problems in its 13G disclosure requirements or proposed Rule 14a-11.

## V. CONCLUSION

The *CA* case and the recent change to Delaware corporate law could fit into the framework of a SEC proxy access rule in that they would allow a shareholder to propose a by-law to set up a procedure for nominating opposing directors, as long as directors were allowed a "fiduciary out" when they did so. This would be in accord with the SEC's 2007 Rule 14a-8 proposal.<sup>163</sup> After such a by-law is passed, shareholders could then take advantage of the procedures outlined in proposed Rule 14a-17 and nominate directors in opposition to the incumbent board of directors' slate. Under this regime, it would appear that Delaware law and the formulation in the SEC's 2007 proxy access proposals would not be in conflict. Whether conflicts could arise in other states is another issue. In any event, in its 2009 proposal, the SEC has ignored or overridden state law and instead set out to please activist institutional investors who have lobbied for proxy access. If the rule is passed in its present form, it is likely to spawn years of litigation.<sup>164</sup>

Further, neither Delaware law nor the SEC proxy rules have yet come to grips with the issue of which shareholders should be permitted to propose directors in opposition to the incumbent directors' nominees, and whether such dissident directors should appear on the company proxy. Under *CA*, is this a matter to be relegated to the fiduciary consideration of the incumbent directors? Alternatively, will Delaware chancery judges and the Delaware Supreme Court re-examine their decisions on the separation of legal and economic ownership in this context? If the legislature leaves this issue to be determined by a corporation's by-laws, will directors seize the opportunity to define shareholders eligible to nominate directors on the company's proxy very narrowly? Alternatively, will activist shareholders attempt to define such eligibility very broadly? Also, will the SEC's rule override any such attempts at private ordering?

The SEC could embark upon reform with regard to proxy and hidden voting by amending Forms 13D, 13G, and 13F to have better disclosure of empty and hidden voting. Then, in any proxy access rule, the SEC could compel shareholders to represent that they have continuously had economic ownership of shares for whatever requisite period the SEC decides

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163. See Shareholder Proposals, *supra* note 96.

164. See 2009 Letter From Rubin to Murphy, *supra* note 147, at 35-38.

is an appropriate condition for shareholder proposals or shareholder director nominations.

My view that shareholder access should not be easily granted is based on the predicate that proxy contests are not generally in a corporation's best long-term interests. Such contests should be encouraged by the SEC only in circumstances where a board has acted with demonstrated indifference to shareholder interests. Further, proxy access should not be allowed to become a mechanism for effecting change of control on the cheap by empty voters. Hedging, stock lending, and similar practices by active institutional investors may be in their economic interests as traders, but do not qualify them to become shareholders who should be able to challenge an incumbent board of directors' selections for the board on the company's ballot. Because the shareholder franchise is an important accountability mechanism, it should be protected from exploitation by large shareholders whose interests and loyalties are not necessarily aligned with other shareholders (especially retail shareholders), or the corporation, just as the shareholder franchise is protected from exploitation by incumbent managers and directors.



