CORPORATIONS

A COMMENT ON THE SEC'S SHAREHOLDER ACCESS PROPOSAL

*BY STEPHEN M. BAINBRIDGE**

I. Introduction

The Securities and Exchange Commission (SEC, or the "Commission") recently proposed a dramatic shakeup in the process by which corporate directors are elected.[1] At present, the director nomination machinery is under the control of the incumbent board of directors. When it is time to elect directors, the incumbent board nominates a slate, which is then put forward on the company's proxy statement. Because the SEC's shareholder-proposal rule cannot be used to nominate directors,[2] a shareholder who wishes to nominate directors is obliged to incur the considerable expense of conducting a proxy contest to elect a slate in opposition to that put forward by the incumbents. This is the situation the SEC proposes to change. If adopted, proposed new Rule 14a-11 would permit shareholders, upon the occurrence of certain specified events and subject to various restrictions, to have their nominees placed on the company's proxy statement and ballot. A shareholder-nominated director thus could be elected to the board in a fashion quite similar to the way shareholder-sponsored proposals are now put to a shareholder vote under SEC Rule 14a-8.[3]

Part II of this commentary discusses the proposal's main points and identifies several significant interpretative issues raised by it. Part III addresses whether the SEC has authority to adopt Rule 14a-11, as proposed. Finally, Part IV addresses the proposal's cost and benefits.

II. An Overview

A. The Proposal

As proposed, Rule 14a-11 contemplates a two-step process stretching over two election cycles. Under the rule, a shareholder may place his or her nominee on the corporation's proxy card and statement if one of two triggering events occurs:

1. A shareholder proposal is made under Rule 14a-8 to authorize shareholder nominations, which is then approved by the holders of a majority of the outstanding shares at a meeting of the shareholders; or
2. Shareholders representing at least 35% of the votes withhold authority on their proxy cards for their shares to be voted in favor of any director nominated by the incumbent board of directors.

At the next annual meeting of the shareholders at which directors are to be elected, shareholder nominees would be included in the company's proxy statement and ballot.[4] As proposed, the SEC contemplates that the triggering event could occur during the proxy season beginning in January 2004.

Not all shareholders would be entitled to make use of the nomination process, however. Only shareholders satisfying four criteria would have access to the company's proxy materials; namely, a shareholder or group of shareholders who:

1. beneficially own more than 5% of the company's voting stock and have held the requisite number of shares continuously for at least two years as of the date of the nomination,
2. state an intent to continue owning the requisite number of securities through the date of the relevant shareholders meeting,
3. are eligible to report their holdings on Schedule 13G rather than Schedule 13D, and
4. have filed a Schedule 13G before their nomination is submitted to the corporation.[5]

Because the eligibility requirements for use of Schedule 13G include a disclaimer of intent to seek control of the corporation,[6] proposed Rule 14a-11 supposedly will not become a tool for corporate acquisitions.

Data reported in the SEC's proposing release suggest that 42% of registered issuers already have at least one shareholder who would be able to make use of Rule 14a-11,[7] although one must wonder how many of those companies are already *de facto* controlled by that shareholder. If most are, the key issue with respect to how often Rule 14a-11 will be used in practice is not how many corporations already have one or more large shareholders, but rather how many have a handful of institutional investors, each owning perhaps 1% of the company's shares, who would band together to form the requisite group.

The number of nominees who may be put forward by a qualifying shareholder depends on the number of board positions. A company whose board consists of eight or fewer directors would be required to include one security holder nominee. A company with a board of directors having more than eight but fewer than twenty members would be obliged to include two shareholder nominees. A company with twenty or more board members would be obliged to allow three nominees to be included on the proxy materials. Where the terms of the board members are staggered, the relevant consideration

is the size of the board as a whole rather than the size of the class to be elected in that year.

In order for an individual to be eligible to be nominated, that individual must satisfy the applicable stock exchange definition of independence from the company. To avoid the use of surrogate director nominees by the incumbents, there can be no agreement between the nominee or nominating group and the company. Perhaps more surprising, however, the proposal also contemplates that the nominee will satisfy a number of independence criteria (e.g., no family or employment relationships) vis-à-vis the nominating shareholder or group. The SEC clearly is concerned that the proposal would be used to put forward special-interest directors who would not represent the shareholders as a whole but only the narrow interests of those who nominated them.

As with Rule 14a-8, the nominating shareholder would be allowed to include a supporting statement of up to 500 words. In order to broadly solicit proxies in favor of the nominee, however, the shareholder would either have to qualify for one of the limited solicitation exemptions[8] or conduct a proxy contest with his or her own proxy statement.

B. The Possible Third Trigger

In addition to the two triggering events incorporated into the rule as proposed, the SEC solicited comments on a possible third triggering event with three criteria:

> [A] A security holder proposal submitted pursuant to Exchange Act Rule 14a-8, other than a direct access security holder proposal,[9] was submitted for a vote of security holders at an annual meeting by a security holder or group of security holders that held more than 1% of the company's securities entitled to vote on the proposal for one year and provided evidence of such holdings to the company;
>
> [B] The security holder proposal received more than 50% of the votes cast on that proposal; and
>
> [C] The board of directors of the company failed to implement the proposal by the 120th day prior to the date that the company mailed its proxy materials for the [subsequent] annual meeting.[10]

As the SEC acknowledged, adopting this trigger would invite time-consuming disputes on such minutiae as whether the board failed to implement the proposal.

There is a more fundamental flaw with this third trigger, however. State corporate law provides that the key player in the statutory decisionmaking structure is the corporation's board directors.[11] As the Delaware code puts it, the corporation's business and affairs "shall be managed by or under the direction of a board of directors."[12] The vast majority of corporate decisions accordingly are made by the board of directors alone (or by managers acting under delegated authority). Shareholders essentially have no power to initiate corporate action and, moreover, are entitled to approve or disapprove only a very few board actions. The statutory decisionmaking model thus is one in which the board acts and shareholders, at most, react.

The proposed trigger shifts that balance of power in favor of the shareholders. At present, the vast majority of shareholder proposals under SEC Rule 14a-8 must be phrased as recommendations rather than as directives to the board.[13] If a precatory proposal passes but the board of directors decides after due deliberation not to accept the shareholders' recommendation, the board's decision currently is protected by the business judgment rule. Hence, the board's power of direction is insulated from being trumped by the shareholders.

To be sure, the proposed trigger would not mandate that boards implement precatory proposals. It would, however, ratchet up the pressure on boards to accede to shareholder proposals even when the board in the exercise of its business judgment believes the proposal to be unwise. As we shall see, if adopted, Rule 14a-11 would impose significant direct and indirect costs on the corporation. In order to avoid a shareholder nomination contest, the board therefore might implement a proposal it deems unsound.

C. Relationship to State Law and a Possible Opt-Out

As proposed, Rule 14a-11 applies only to those corporations whose shareholders have a state-law right to nominate candidates for election to the board:

> [T]he security holder nomination procedure would be available unless applicable state law prohibits the company's security holders from nominating a candidate or candidates for election as a director. If state law permits companies incorporated in that state to prohibit security holder nominations through provisions in companies' articles of incorporation or bylaws, the proposed procedure would not be available to security holders of a company that had included validly such a provision in its governing instruments.[14]

In effect, where state law permits, corporations thus would be permitted to opt out by adopting appropriate charter or bylaw provisions.[15]

Does state law permit the necessary opt-out provision? Delaware law has a fairly strong streak of freedom of contract. As Vice Chancellor Leo Strine explained in a

recent decision, *Harrah's Entertainment, Inc. v. JCC Holding Co.*,[16] a corporation may opt out of the default voting—and nominating—rules of state law, provided it does so clearly and unambiguously:

> When a corporate charter is alleged to contain a restriction on the fundamental electoral rights of stockholders under default provisions of law—such as the right of a majority of the shares to elect new directors or enact a charter amendment—it has been said that the restriction must be "clear and unambiguous" to be enforceable.[17]

Vice Chancellor Strine's opinion in *Harrah's* thus suggests an affirmative answer to the question of whether the required opt-out provision is authorized by state law, albeit with qualifications:

> Because of the obvious importance of the nomination right in our system of corporate governance, Delaware courts have been reluctant to approve measures that impede the ability of stockholders to nominate candidates. Put simply, Delaware law recognizes that the "right of shareholders to participate in the voting process includes the right to nominate an opposing slate." And, "the unadorned right to cast a ballot in a contest for [corporate] office ... is meaningless without the right to participate in selecting the contestants. As the nominating process circumscribes the range of choice to be made, it is a fundamental and outcome-determinative step in the election of officeholders. To allow for voting while maintaining a closed selection process thus renders the former an empty exercise."[18]

Because restrictions on shareholder voting rights, such as a departure from the one share-one vote norm, must be in the articles of incorporation, per DGCL § 212, it would be advisable to include any restriction on shareholder nominations in the articles rather than the bylaws.[19] For existing companies, getting the shareholders to approve a charter amendment banning shareholder nominations will probably be difficult; few firms likely would even try to buck the inevitable bad press and institutional investor complaints. Assuming the rule goes through in present form, however, it will be interesting to see how many IPOs include such a provision.

Another wrinkle is suggested by the 1990 takeover fight between BTR plc, a U.K. holding company, and Norton Co., a Massachusetts corporation. Norton's incumbent managers wanted to classify their board of directors as a takeover defense, but knew they had neither the time nor the shareholder support to get approval of an amendment to their articles. Norton's managers therefore went to the Massachusetts legislature, which passed H.B. 5556, which classified, by operation of law, the boards of directors of all Massachusetts corporations having a class of securities registered under the federal Securities Exchange Act.[20] As proposed, Rule 14a-11 seems vulnerable to just such a blanket state exemption. Alternatively, a state presumably could also undermine Rule 14a-11 by providing for three year director terms, for example, rather than the current one-year default.[21]

D. The Relationship with Rule 14a-8

Corporations currently must expend considerable sums on shareholder proposals under Rule 14a-8. According to the SEC's own figures, the cost per company of determining whether or not a 14a-8 proposal should be included in the proxy statement is $37,000, and the direct cost per company of including a proposal is $50,000.[22] ISS tracked 1,042 shareholder proposals in the 2003 proxy season.[23] Assuming that corporations seek to exclude all proposals, which implies a cost of $87,000 per proposal, we can estimate total annual expenditures on shareholder proposals at $90,654,000.[24]

If corporations are to be allowed to opt-out of Rule 14a-11, why should they not also be allowed to opt out of Rule 14a-8? The shareholder-proposal rule has become an increasingly costly mechanism by which social activists, unions, and public pension fund managers hijack the corporate proxy statement as a soapbox for multiple proposals that often have little to do with shareholder welfare. Granted, there is increasing use of the rule for what purport to be governance proposals, but do the benefits justify the costs? If it makes sense to let firms opt out of Rule 14a-11, there is no good reason to forbid them from doing so with respect to Rule 14a-8.

At the very least, the SEC should consider allowing corporations to exclude precatory shareholder proposals in any election cycle in which Rule 14a-11 has been triggered. Precatory proposals cost a small fraction of what Rule 14a-11 will cost, of course, but their costs still amount to a considerable sum.[25] If shareholders want to put corporations to the expense of a contested director election, perhaps they should be obliged to forego putting the corporation to the added expense of dealing with precatory proposals.

III. Does the SEC have the Requisite Authority?

Section 14(a) of the Securities Exchange Act of 1934 is the basic federal proxy statute.[26] It is not self-executing, however. Instead, Section 14(a) merely prohibits solicitation of proxies unless the solicitor complies with the proxy rules promulgated by the SEC.

The SEC has long claimed that the rulemaking authority granted it by Section 14(a) sweeps very broadly. In July 1988, the Commission made its most dramatic assertion to date of authority under Section 14(a) by adopting Rule 19c-4.[27] Rule 19c-4 amended the rules of the self-regulatory organizations to prohibit an issuer's equity

securities from being listed on national securities exchanges or on NASDAQ if the issuer issued securities or took other corporate action nullifying, restricting, or disparately reducing the voting rights of existing shareholders. The rule was intended to restrict the ability of U.S. corporations to adopt dual-class stock plans in which different classes of voting stock have disparate voting rights. In June 1990, the United States Court of Appeals for the District of Columbia invalidated Rule 19c-4 on the grounds that the Commission had exceeded the statutory authority delegated to it by Congress.[28] In doing so, the court sharply limited the SEC's Section 14(a) powers over substantive aspects of shareholder voting.

In defending Rule 19c-4, the SEC advanced its longstanding view that Exchange Act Section 14(a) was intended to promote corporate democracy. In striking down Rule 19c-4, however, the D.C. Circuit adopted a much narrower view of Section 14(a)'s purposes. According to the court, federal proxy regulation has two principal goals. First, and foremost, it regulates the disclosures shareholders receive when they are asked to vote. Second, it regulates the procedures by which proxy solicitations are conducted. Section 14(a)'s purposes thus do not include regulating substantive aspects of shareholder voting. While confirming that the SEC has extensive authority to adopt rules assuring full disclosure and fair solicitation procedures, the *Business Roundtable* decision thus also drew a critical distinction between substantive and procedural regulation of shareholder voting. As to the former, the SEC has little, if any, authority.

The court's *Business Roundtable* decision recognized the "murky area between substance and procedure," in which rules may resist classification. Nonetheless, the opinion offers a few signposts by which the validity of Rule 14a-11 can be resolved. In particular, consider the distinction the court drew between Rule 19c-4 and Rule 14a-4(b)(2)'s requirement that proxies give shareholders an opportunity to withhold authority to vote for individual director nominees. In the court's view, the latter "bars a kind of electoral tying arrangement, and may be supportable as a control over management's power to set the voting agenda, or, slightly more broadly, voting procedures," while "Rule 19c-4 much more directly interferes with the substance of what shareholders may enact."[29]

On which side of the line does Rule 14a-11 fall? In an article I wrote on 19c-4, I concluded that the shareholder-proposal rule would pass muster under the *Business Roundtable* approach.[30] Absent Rule 14a-8, shareholders have no practical means of initiating action in the voting process or otherwise affecting the agenda. As such, I argued, Rule 14a-8 presumably is supportable "as a control over management's power to set the voting agenda."[31] Director-nomination rules would seem to fall into that category as well.

IV. Costs versus Benefits

The SEC contends that Rule 14a-11 is necessary to remove "barriers to meaningful participation in the proxy process" and to address "concern over corporate scandals and the accountability of corporate directors."[32] In my view, however, the benefits the proposal offers in these areas are quite modest at best, and are likely to be outweighed by the costs imposed by the rule.

A. Direct Costs

What will Rule 14a-11 cost affected corporations? A review of proxy contests in a late-1980s survey found that insurgents spent an average of $1.8 million and incumbents an average of $4.4 million.[33] Proxy contest costs almost certainly are much higher today, but for the sake of conservatism I have used the late-1980s data as a baseline. Assume that a company faces a Rule 14a-11 contested director election every three years. Assume further that a Rule 14a-11 contested election costs one-third what a full proxy contest costs. On those assumptions, each public corporation would face annualized costs of about $500,000. Using the 10,000 actively traded U.S. companies in the Compustat database as a proxy for the number of companies potentially subject to Rule 14a-11, we can estimate an aggregate annual cost of $5 billion. Admittedly, this analysis likely overestimates both the number of contests and the cost of each contest.

An alternative estimate could use the annual cost of Rule 14a-8 shareholder proposals as a baseline. Recall that, according to the SEC's own figures, the cost per company of including a shareholder proposal in the proxy statement is $87,000. Also recall that ISS tracked 1,042 shareholder proposals at public corporations during the 2003 proxy season, which gives us total annual corporate expenditures on shareholder proposals of $90,654,000. Granted, it is unlikely there will be as many Rule 14a-11 election contests as Rule 14a-8 shareholder proposals. On the other hand, incumbent boards likely will spend considerably more on opposing each Rule 14a-11 contest than on opposing a Rule 14a-8 shareholder proposal. As such, $100 million may not be a bad estimate for the lower boundary of the range within which Rule 14a-11's direct costs will fall.

B. The Costs and Benefits of Promoting Shareholder Democracy

As noted, a chief claimed benefit of Rule 14a-11 is its contribution to shareholder democracy. U.S. corporate law, however, is far more accurately described as a system of director primacy than one of shareholder primacy.[34] As Berle and Means famously demonstrated, U.S. public corporations are characterized by a separation of ownership and control.[35] The firm's nominal owners, the shareholders, exercise virtually no control over either day-to-day operations or long-term policy.[36] Instead, control is vested in the hands of professional managers, who typically own only a small portion of the firm's shares.[37]

Some commentators have argued for reducing the extent to which ownership and control are separated by promoting shareholder democracy, a goal the SEC has advanced to justify Rule 14a-11. Most of these scholars acknowledge that the rational apathy of small individual shareholders precludes such investors from playing an active role in corporate governance, even setting aside the various legal impediments to shareholder activism. Instead, these scholars focus on institutional investors, such as pension and mutual funds.[38]

As the theory goes, institutional investors will behave quite differently from dispersed individual investors. Because they own large blocks, and have an incentive to develop specialized expertise in making and monitoring investments, institutional investors could play a far more active role in corporate governance than dispersed shareholders. Institutional investors holding large blocks thus have more power to hold management accountable for actions that do not promote shareholder welfare. Their greater access to firm information, coupled with their concentrated voting power, might enable them to more actively monitor the firm's performance and to make changes in the board's composition when performance lags.

There is relatively little evidence that institutional investor activism has mattered, however. Large blocks held by a single institution remain rare, as few U.S. corporations have any institutional shareholders who own more than 5-10% of their stock.[39] Even the most active institutional investors spend only trifling amounts on corporate governance activism. Institutions devote little effort to monitoring management; to the contrary, they typically disclaim the ability or desire to decide company-specific policy questions.[40] They rarely conduct proxy solicitations or put forward shareholder proposals.[41] Not surprisingly, empirical studies of U.S. institutional investor activism have found "no strong evidence of a correlation between firm performance and percentage of shares owned by institutions."[42]

Some former advocates of institutional investor activism have therefore retreated to the more modest claim that "it's hard to be against institutional investor activism."[43] Yet, even this last revisionist redoubt fails to adequately acknowledge that the purported benefits of institutional control, if any, may come at too high a cost. As even one of the most prominent proponents of institutional investor activism conceded, for example, there is good evidence that bank control of the securities markets has harmed Japanese and German economies by impeding the development of new businesses.[44]

Because we are concerned with the governance of large publicly held corporations, however, this essay focuses on a different concern: the risk that institutional investors may abuse their control by self-dealing and other forms of over-reaching. In his important study of institutional ownership, Mark Roe contended that large-block holders can improve firm performance by personifying the shareholder community.[45] He argued that loyalty to real people may be a better motivator than loyalty to an abstract collection of small shareholders.[46] The trouble, of course, is that the interests of large and small investors often differ.[47] If the board becomes more beholden to the interests of large shareholders, it may become less concerned with the welfare of smaller investors.

Let us assume, however, that interests of individual and institutional investors are congruent. As I have argued elsewhere in detail,[48] institutional investor activism would still be undesirable if the separation of ownership and control mandated by U.S. law has substantial efficiency benefits. Berle and Means, of course, believed that the separation of ownership and control was both a departure from historical norms and a serious economic problem.[49] They likely were wrong on the former score, although that is a question beyond the scope of this essay.[50] As to the latter, the separation of ownership and control is a highly efficient solution to the decisionmaking problems faced by large corporations.

Kenneth Arrow's work on organizational decisionmaking identified two basic decisionmaking mechanisms: "consensus" and "authority."[51] Consensus is utilized where each member of the organization has identical information and interests, which facilitates collective decisionmaking. In contrast, authority-based decisionmaking structures arise where team members have different interests and amounts of information. Because collective decisionmaking is impracticable in such settings, authority-based structures are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole.[52]

The modern public corporation precisely fits Arrow's model of an authority-based decisionmaking structure. Shareholders have neither the information nor the incentives necessary to make sound decisions on either operational or policy questions. Overcoming the collective-action problems that prevent meaningful shareholder involvement would be difficult and costly. Rather, shareholders will prefer to irrevocably delegate decisionmaking authority to some smaller group. Separating ownership and control by vesting decisionmaking authority in a centralized entity distinct from the shareholders is thus what makes the large public corporation feasible.

To be sure, this separation results in the well-known agency-cost problem. Agency costs, however, are the inevitable consequence of vesting discretion in someone other than the shareholders. We could substantially reduce, if not eliminate, agency costs by eliminating discretion; that we do not do so suggests that discretion has substantial virtues. A complete theory of the firm thus

requires one to balance the virtues of discretion against the need to require that discretion be used responsibly. Neither discretion nor accountability can be ignored, because both promote values essential to the survival of business organizations. Unfortunately, however, they also are antithetical—at some point, one cannot have more of one without also having less of the other. This is so because the power to hold to account is ultimately the power to decide. As Kenneth Arrow explained:

> [Accountability mechanisms] must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.[53]

Hence, directors cannot be held accountable without undermining their discretionary authority. Establishing the proper mix of discretion and accountability thus emerges as the central corporate governance question.

The root economic argument against shareholder activism thus becomes apparent. Large-scale investor involvement in corporate decisionmaking seems likely to disrupt the very mechanism that makes the public corporation practicable: the centralization of essentially nonreviewable decisionmaking authority in the board of directors. The chief economic virtue of the public corporation is not that it permits the aggregation of large capital pools, as some have suggested, but rather that it provides a hierarchical decisionmaking structure well suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs. In such a firm, someone must be in charge: "Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success."[54] While Roe argues that shareholder activism "differs, at least in form, from completely *shifting* authority from managers to" institutions,[55] it is in fact a difference in form only. Shareholder activism necessarily contemplates that institutions will review management decisions, step in when management performance falters, and exercise voting control to effect a change in policy or personnel. For the reasons identified above, giving institutions this power of review differs little from giving them the power to make management decisions in the first place. Even though institutional investors probably would not micromanage portfolio corporations, vesting them with the power to review major decisions inevitably shifts some portion of the board's authority to them.

Given the significant virtues of discretion, one ought not lightly interfere with management or the board's decisionmaking authority in the name of accountability. Preservation of managerial discretion should always be the null hypothesis. The separation of ownership and control mandated by U.S. corporate law has precisely that effect. To the extent Rule 14a-11 empowers shareholders to review board decisions, it weakens the very foundation of U.S. corporate law: the principle of director primacy.

C. The Effect on Board Governance

A proponent of Rule 14a-11 likely would respond that the rule does not give shareholders the power to reverse board decisions, but only a power to replace one board member.[56] Fair enough, but there are sound reasons to believe that Rule 14a-11 would lead to worse rather than better corporate governance. The problem is that introduction of a shareholder representative is likely to trigger a reduction in board effectiveness.

The impact of a shareholder right to elect board members on the effectiveness of the board's decisionmaking processes will be analogous to that of cumulative voting. Granted, some firms might benefit from the presence of skeptical outsider viewpoints. It is well-accepted, however, that cumulative voting tends to promote adversarial relations between the majority and the minority representative. The likelihood that cumulative voting will results in affectional conflict rather than cognitive conflict[57] thus leaves one doubtful as to whether firms actually benefit from minority representation.

The likelihood of disruption of effective board processes is confirmed by the experience of German firms with codetermination.[58] German managers sometimes deprive the supervisory board of information, because they do not want the supervisory board's employee members to learn it. Alternatively, the board's real work is done in committees or *de facto* rump caucuses from which employee representatives are excluded. As a result, while codetermination raises the costs of decisionmaking, it seemingly does not have a positive effect on substantive decisionmaking.[59]

The likely effect of electing a shareholder representative therefore will not be better governance. It will be an increase in affectional conflict (as opposed to the more useful cognitive conflict). It will be a reduction in the trust-based relationships that cause horizontal monitoring within the board to provide effective constraints on agency costs. It will be the use of pre-meeting caucuses and a reduction in information flows to the board. A chief indirect cost of Rule 14a-11 therefore will be less effective governance.

Conclusion

History teaches that market bubbles are fertile ground for fraud. Cheats abounded during the Dutch tulip-bulb mania of the 1630s. The South Sea Company, which was at the center of the English stock market bubble

in the early 1700s, was itself a pyramid scheme. No one should have been surprised that fraudsters and cheats were to be found when we started turning over the rocks in the rubble left behind when the stock market bubble burst in 2000.

Corporate scandals are always good news for big-government types. After every bubble bursts, going all the way back to the South Sea Bubble, a slew of new laws have been enacted. Why? There is nothing a politician or regulator wants more than to persuade angry investors that he or she is "doing something" and being "aggressive" in rooting out corporate fraud.

Hence, it was entirely predictable that the shenanigans at Enron, WorldCom, et al., coming after several years of steady decline in the stock market, would lead to regulation. Yet, how quickly we forget. Remember what Ronald Reagan said: "The nine most terrifying words in the English language are: 'I'm from the government and I'm here to help.'"

Like a cook who throws spaghetti at the wall to see if it's done, legislators and regulators have been throwing a lot of new rules at corporations to see what sticks: Sarbanes-Oxley, numerous SEC regulations, California's onerous corporate disclosure act, New York Attorney General Spitzer's settlement with the analyst community, and countless law suits and indictments. Unlike the cook, who stops when the spaghetti is done, the lawmakers just keep throwing things at corporations without stopping to ask whether enough is enough.

The costs of all this regulatory activity are beginning to mount up. Some companies, for example, will incur 20,000 staff hours to comply with just one SEC new rule – a rule the SEC estimated would require only 383 staff hours per firm.[60] According to a study by Foley Lardner, "[s]enior management of public middle market companies expect costs directly associated with being public to increase by almost 100% as a result of corporate governance compliance and increased disclosure as a result of the Sarbanes-Oxley Act of 2002 (SOX), new SEC regulations and changes to [stock] exchange listing requirements."[61] If adopted, the SEC's shareholder access proposal would significantly add to that regulatory burden.

If the SEC could figure out a way to limit the proposal to situations in which the board is clearly dysfunctional, these concerns might be less important. The problem is that the SEC is letting the tail wag the dog. The evidence strongly suggests that most companies are well-managed. As the Wall Street Journal explained:

> The economy and stock market have performed better in recent years than any other on earth. "How can we have done marvelously if the system is fundamentally flawed?" [economist Bengt] Holmstrom asks. If the bulk of American executives were stealing from shareholders and financial markets were rigged, they reason, then capital would flow to the wrong places and productivity wouldn't be surging.[62]

The SEC's rules apply to all public corporations, however, whether their internal governance is good, bad, or just indifferent. As currently drafted, nothing in either trigger limits the rule to the Enrons of the world. If enough shareholders are disgruntled, for whatever reason, they can force a vote. This makes no sense. The point of all these reforms, supposedly, is to restore investor confidence by ensuring good corporate governance. But if firms are well-managed, why put them to the expense and bother of a shareholder nomination contest?

*Stephen M. Bainbridge is a Professor at UCLA School of Law.

Footnotes

[1] Proposed Rule: Security Holder Director Nominations, SEC Exchange Act Rel. No. 48626 (Oct. 14, 2003), available at <http://www.sec.gov/rules/proposed/34-48626.htm>. The release is quite staggering. One commentator observed: "The release fills 107 pages, contains 238 footnotes and, incredibly, poses over 320 separate questions for consideration by commenters." <http://www.corplawblog.com/archives/000250.html>.

[2] *See* 17 CFR 240.14a-8(i)(8).

[3] 17 CFR 240.14a-8.

[4] More precisely, the shareholders' right of access to the company's proxy statement would remain in effect for (1) the remainder of the calendar year in which a triggering event occurs; (2) the subsequent calendar year; and (3) a portion of the second calendar year following the calendar year in which the triggering event occurs, up to and including the annual meeting of the shareholders held during that calendar year. Exchange Act Rel. No. 48626, *supra* note 1.

[5] *Id*.

[6] 17 CFR 240.13d-1(b).

[7] Exchange Act Rel. No. 48626, *supra* note 1. In the event more than one shareholder or shareholder group puts forward a nominee, only the nominee proposed by the largest holder need be included in the company's proxy materials. *Id.*

[8] SEC Rule 14a-2 exempts from the proxy rules a number of situations in which a shareholder contacts other shareholders, such as when the shareholder only contacts ten or fewer other shareholders. 17 CFR 240.14a-2.

[9] This exception means that the trigger would be invoked only by shareholder proposals addressing issues other than shareholder access. It might be invoked, for example, where the shareholders approve a proposal recommending repeal of a poison pill and the board of directors fails to act.

[10] Exchange Act Rel. No. 48626, *supra* note 1.

[11] All state corporate codes provide for a system of nearly absolute delegation of power to the board of directors, which in turn is authorized to delegate power to subordinate firm agents. *See* Model Bus. Corp. Act Ann. § 8.01 cmt. (1995) (reviewing statutes).

[12] Del. Code. Ann., tit. 8, § 141(a) (2001).

[13] *See* 17 CFR 240.14a-8(i)(1), which provides that shareholder proposals must be a proper subject for shareholder action under state law. Because shareholders have such limited powers to initiate corporate action, most shareholder proposals would be excludible under this pro-

vision were it not for the SEC's position that precatory proposals must be included even if the shareholders lack the requisite power to insist on their implementation.
[14] Exchange Act Rel. No. 48626, *supra* note 1.
[15] Although proposed Rule 14a-11 represents a fairly dramatic expansion of the federal role in corporate governance, I do not address herein the federalism implications of the proposal. First, as discussed below (*infra* Part III), it seems clear that the SEC has authority to adopt the proposal. Second, because the SEC has provided the state-law-based opt-out provision, the preemptive effect of the proposal on state corporate law is mitigated. For an argument against federalization of corporate law, see Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REGULATION, Spring 2003, at 26.
[16] 802 A.2d 294 (Del.Ch. 2002).
[17] *Id.* at 310.
[18] *Id.* at 310-11 (citations omitted).
[19] Not only would a bylaw provision be of dubious enforceability, but under DGCL § 109(a) the shareholders always retain the right to initiate amendments to the bylaws.
[20] *See generally* Stephen M. Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 WIS. L. REV. 1071, 1090.
[21] Note that with a classified board there still is an annual election, even though each director's individual term will be 3 years. I'm referring to a situation in which there would only be one election every three years.
[22] <http://www.sec.gov/rules/final/34-40018.htm>.
[23] <http://www.dlbabson.com/dlbindex/1,5243,8-23-59-509,00.html>.
[24] Note that this estimate may be conservative, as it does not include sums spent on proposals corporations successfully excluded. On the other hand, of course, it is doubtful that all proposals were resisted.
[25] Precatory proposals not only impose direct costs, but also lengthen the proxy statement, raising the opportunity costs to shareholders of making informed decisions.
[26] 15 U.S.C. § 78n(a).
[27] *See generally* Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. UNIV. L.Q. 565 (1991).
[28] Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).
[29] *Id.* at 411.
[30] Bainbridge, *supra* note 25, at 621-22.
[31] *Id.* at 622.
[32] Exchange Act Rel. No. 48626, *supra* note 1.
[33] *See* RANDALL S. THOMAS & CATHERINE T. DIXON, ARANOW & EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL § 21.01 (3d ed. 1998).
[34] *See generally* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003)
[35] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 66 (1932).
[36] *Id.* at 82.
[37] *Id.*
[38] *See*, e.g., MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990). For more skeptical analyses, see Edward Rock, *The Logic and Uncertain Significance of Institutional Investor Activism*, 79 GEO. L.J. 445 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163 (1991).
[39] *See* Black, *supra* note 37, at 567-68 (summarizing data).
[40] *See* Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459, 460 (1998) (noting that even "activist institutions spend less than half a basis point of assets … on their governance efforts").
[41] *Id*.
[42] *Id*. at 462.
[43] *Id.*
[44] ROE, *supra* note 37, at 256.
45 *Id.* at 237-38.
46 *Id.*
[47] Rock, *supra* note 37, at 466-68; Rosenbaum, *supra* note 37, at 176-79.
[48] *See generally* Stephen M. Bainbridge, *Director v. Shareholder Primacy in the Convergence Debate*, 16 TRANSNATIONAL LAW. 45 (2002), on which the following discussion draws.
[49] BERLE & MEANS, *supra* note 34, at 3-10 (discussing a perceived transition in the nature of the corporation and describing the purported consequences thereof).
[50] The classic debunking of Berle and Means' historical account remains Walter Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611 (1981).
[51] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68-70 (1974).
[52] *Id.* at 68-69.
[53] *Id.* at 78.
[54] *Id.* at 69.
[55] ROE, *supra* note 37, at 184 (emphasis in original).
[56] Companies are already having a hard time attracting independent directors. The shareholder access proposal likely will make that search even harder. Why would somebody be willing to serve on the board if he or she might be the one singled out to be ousted?
[57] A classic example of cognitive conflict occurs during brainstorming sessions, when people vigorously bounce ideas off one another. Affectional conflict occurs when brainstorming sessions devolve into ad hominem arguments.
[58] In Germany alone, there are at least four different statutory models of participatory management. Klaus J. Hopt, *Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe*, 14 INT'L REV. L. & ECON. 203, 204 (1994). Some other member-states of the European Union also have some form of employee representation, and there have long been proposals to develop harmonized company laws or even a European Union-wide company law that would provide for employee representation. *See generally* Terence L. Blackburn, *The Societas Europea: The Evolving European Corporation Statute,* 61 FORDHAM L. REV. 695, 743-55 (1993). Codetermination includes a dual board structure: a supervisory board that appoints a managing board, with the latter actively operating the firm. Workers are represented only on the former. The supervisory board concept is difficult to translate into terms familiar to those trained exclusively in U.S. forms of corporate governance. Its statutory mandate is primarily concerned with the appointment and supervision of the managing board. Hopt, *supra*, at 204. In theory, employees and shareholders are equally represented on the supervisory board. In practice, however, the board is often controlled either by the firm's managers or by a dominant shareholder. *Id.* One of the employee representatives must be from management, and shareholders are entitled to elect the chairman of the board, who has the power to break tie votes. If push comes to shove, which it reportedly rarely does, id., shareholders thus retain a slight but potentially critical edge.
[59] *See generally* Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979 (1998).
[60] <http://slw.issproxy.com/securities_litigation_blo/2003/10/20000_hours_to_.html>.
[61] <http://www.foley.com/publications/pub_detail.aspx?pubid=1382>.
[62] David Wessel, *"The American Way" is a Work in Progress,* WALL ST. J., Nov. 13, 2003, at A2.