THE ICONIC CASES IN CORPORATE LAW

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Chapter 4

THE TRANSAMERICA CASE

By
*Jill E. Fisch**

It may seem odd for a book entitled *Iconic Cases in Corporate Law* to include a chapter about the Transamerica decision.[1] Transamerica, after all, is a decision by a federal court, interpreting the proxy rules adopted by the United States Securities and Exchange Commission pursuant to its authority under the federal securities laws. Characterizing Transamerica as a building block of U.S. corporate law appears to run counter to the traditional distinction between state corporate law and the securities laws which, in contrast to corporate law are mandatory, adopted by Congress and, through its delegated rule-making authority, the SEC, and focused on securities transactions rather than the internal affairs of the corporation. Concededly the distinction between corporate law and securities law is neither clear nor absolute. The subject of shareholder voting perhaps best illustrates the uncertain boundary between the two. Of the issues regulated by the federal securities law, the proxy rules reflect the most extensive intrusion law into the internal affairs of the corporation. This intrusion was not apparent at the time that Congress enacted the federal securities laws, nor is it obvious from the text of the federal statutes themselves. Nonetheless, the SEC, through the adoption and enforcement of the federal proxy rules, has taken substantial—some might say primary—responsibility for delineating the scope of shareholder voting rights. Through its regulation of shareholder voting, the SEC has played a critical role in determining the extent to which shareholders, through the exercise of voting rights, can exercise power over corporate management.

Although at the time, the Transamerica decision represented a watershed event in support of shareholder voting power, the SEC almost immediately began to retreat from its role as shareholder advocate.

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1. SEC v. Transamerica Corp., 163 F.2d 511 (3d Cir. 1947).

Through its repeated amendments to the federal proxy rules and the positions it adopted in subsequent litigation over those rules, the SEC has placed increasing limits on shareholder access to the proxy. More significantly, the SEC's active efforts to determine the appropriate limits on shareholder voting power have put it, and not state courts or legislatures, in the primary position of determining the subjects that are proper for a shareholder vote, the extent to which shareholders can increase their role in corporate governance by amending the corporate bylaws and the appropriate role of shareholders in the nomination of directors.

There are reasons to question the limits imposed by the SEC on shareholder voting.[2] Although the SEC has traditionally portrayed itself as the "investor's advocate,"[3] some critics argue that the SEC has been unduly influenced by corporate management, a concern perhaps most visible in its recent amendments concerning shareholder power to nominate directors.[4] Independent of the substantive merits of the SEC's position, however, there are reasons to question the SEC's decision to federalize shareholder voting rights and to impose universal standards rather than allowing individual state or issuer experimentation and regulation. The Transamerica decision reveals the origins of this process.

A. BACKGROUND TO THE TRANSAMERICA CASE

The background to the Transamerica decision was the SEC's promulgation of rules governing the solicitation of proxies. By the mid 1800s, dispersed ownership of publicly traded stock had made it difficult for shareholders to attend annual meetings in person. Some shareholders sought to appoint a representative or proxy to vote their shares at the meeting. At the same time, issuers began to have difficulty meeting quorum requirements and began to seek proxy voting authority from shareholders in conjunction with providing notice of the annual meeting.

The permissibility of proxy voting was unclear under state law. State courts generally agreed that shareholders had no common law right to vote their stock by proxy, and held that such a right had to be conferred either by statute or in the corporation's charter or by-laws.[5] A

2. One of the better known advocates for increased shareholder voting power is Lucian Bebchuk. See, e.g, Lucian A. Bebchuk, The Myth of the Shareholder Franchise, 93 Va. L. Rev. 675 (2007) (advocating increased shareholder voting power including ballot access and reimbursement of costs).

3. Securities & Exchange Commission, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, avail. at http://www.sec.gov/about/whatwedo.shtml (Nov. 19, 2007).

4. See, e.g., Kara Scannell, Cox, in Denying Proxy Access, Puts His SEC Legacy on Line, Wall. St. J., Nov. 29, 2007, at C1 (describing SEC's adoption of proxy rule amendments as re-opening concern that Chairman Cox would "roll back shareholder rights in favor of business interests.")

5. See, e.g., Market S. R. Co. v. Hellman, 109 Cal. 571 (1895) ("At common law a stockholder has no right to cast his vote by proxy"), quoting Cook on Stock and Stockholders § 610; Leonard H. Axe, Corporate Proxies, 41 Mich. L. Rev. 38 (1942) (explaining that, at common law, proxy voting required "special authorization," typically in the form of a charter or by-law provision).

few courts went further and held that shareholder voting was a personal obligation of the shareholder and could not be delegated—even where permitted by a corporation's charter—absent explicit statutory authority.[6] State legislatures responded to these decisions, first with permissive statutes that authorized proxy voting and subsequently by affirmatively granting shareholders the right to vote by proxy.[7]

By the early 1900s, it had become common for corporations to solicit shareholder proxies for the annual meeting. These proxies generally authorized a management representative, typically the corporate secretary, to vote the shareholder's stock on his or her behalf. It was usual for proxies to be broadly worded, allowing the representative to exercise all rights that the shareholder would have had, if he or she had been present at the annual meeting, including the right to exercise the proxy's own discretion in voting on matters that were not specifically mentioned in the annual meeting notice.[8]

Management at some companies misused this proxy authority, however. Some shareholders were forced or deceived into granting proxy authority.[9] Reports surfaced of corporations issuing dividend checks which provided that the shareholder, by endorsing the check, designated a corporate officer as his or her proxy.[10] It was also "an accepted corporate practice" for management to submit to the shareholders for their approval, all acts and transactions by the corporation's officers and directors during the prior year, and the standard corporate proxy authorized this so-called "ratification" of the acts of management.[11] Through these measures, management was able to obtain shareholder approval of management self-dealing transactions, substantial executive compensation and other abusive transactions.

In the early 1930s, Congress heard testimony concerning these abuses, and when it passed the Securities Exchange Act of 1934, it granted the Commission authority to make rules governing the solicitation of proxies, subject to the proviso that the rules be "necessary or appropriate in the public interest or for the protection of investors."[12] The SEC initially focused its rulemaking on disclosure and the prohibi-

6. See, e.g., Taylor v. Griswold, 14 N.J.L. 222 (1834) (holding that corporation lacks the power to adopt a by-law permitting shareholders to vote by proxy absent legislative authorization).

7. See, e.g., Arthur H. Dean, Non–Compliance with Proxy Regulations: Effect on Ability of Corporation to Hold Valid Meeting, 24 Cornell L. Q. 483, 488 n.11 (1939) (quoting various state statutes granting shareholders the right to vote by proxy).

8. See Dean, supra note 7 at 490 (describing solicitation of proxies prior to the adoption of the Securities Exchange Act of 1934).

9. See, e.g., Rice & Hutchins, Inc. v. Triplex Shoe Co., 16 Del. Ch. 298, 309 (1929) (invalidating effort of management to vote shareholder proxies to ratify self-dealing transactions without advising the stockholders of their intentions).

10. Indeed, this practice seemingly continued after the adoption of the Securities Exchange Act at unlisted corporations that were not subject to the federal proxy rules. See David M. Friedman, SEC Regulation of Corporate Proxies, 63 Harv. L. Rev. 796, 816 n.77 (1950) (citing case described in connection with proposed legislation to extend Regulation 14(a) to unlisted companies).

11. Dean, supra note 11 at 490.

12. Securities Exchange Act of 1934, 15 U.S.C. § 78n(a).

tion of fraud. Specifically, in response to the abuses described above, the SEC required management to provide shareholders with adequate information about the issues on which the proxy was to be voted, as well as any personal interest of the proxy.[13]

In 1939, however, shareholders John and Lewis Gilbert locked horns with Bethlehem Steel.[14] Prior to the annual meeting, the Gilberts had informed management that they intended to move to amend the bylaws to provide for shareholder election of the auditors. When management sent out to shareholders the notice of the annual meeting and the proxy form, it did not mention the Gilbert motion. The management solicitation did not seek general proxy authorization however; it sought voting authority only for the election of directors. Management seemingly assumed that the Gilbert motion would not pass if only those shareholders physically present at the meeting were able to vote on it.

The Gilberts complained to the SEC, and the SEC advised Bethlehem Steel that, in its opinion, the failure to inform shareholders about the motion rendered its proxy solicitation false and misleading. The Commission suggested that the company adjourn the meeting and notify shareholders about the motion. Bethlehem Steel did adjourn the meeting, and wrote to shareholders informing them about the Gilbert motion. Management did not, however, seek voting authority with respect to the Gilbert's motion and, at the annual meeting, the motion was defeated by those shareholders physically present.

The Commission responded the next year by amending the federal proxy rules. As it explained: "The Commission has been seriously concerned regarding the responsibility of corporate management to communicate to security holders information with respect to matters which minority groups have indicated will be brought up for action at a proposed meeting."[15] As a result, it amended Rule X–14A–9(I), renumbered as Rule X–14A–8, to require that, if proxies were to be used to vote at an annual meeting or to provide a quorum, that the proxy solicitation provide notice to shareholders of any matter expected to be raised at the annual meeting, and that the form of proxy provide shareholders with the opportunity to specify their desired action with respect to each such matter.

Just two years later, the Commission went further, adopting its initial version of the shareholder proposal rule. As amended in December 1942, federal proxy rules required that shareholder proposals be included in the company's proxy statement, and that "Stockholders making proposals for action which are opposed by management must be given not more than 100 words in the proxy in which to state their position,

13. Rules LA 1–7, Sec. Exch. Act Rel. No. 378 (Class A), (Sept. 24, 1935).

14. Dean, supra note 7 at 503; John Bainbridge, Profiles, The Talking Stockholder—II, The New Yorker, Dec. 18, 1948 at 33.

15. Sec. Exch. Act Rel. No. 2376, 1999 WL 955899 (Jan. 12, 1940).

provided the security holder gives the management reasonable notice of his intention."[16]

Who were the Gilbert brothers, whose actions at Bethlehem Steel and other companies spurred the Commission's rulemaking efforts? John and Lewis Gilbert were perhaps the best known shareholder activists of all time.[17] The Gilberts were men of independent means, who acquired, largely by inheritance, shares in several hundred corporations. Beginning in the 1930s, the Gilberts embarked on a lifelong crusade to increase shareholder participation in corporate governance. As part of this crusade, the Gilberts regularly attended annual meetings, speaking from the floor and introducing shareholder proposals on a wide variety of corporate governance issues. In the 1940s, the Gilberts typically focused on issues such as proper auditing, the provision of post-meeting reports to shareholders, and convenient location of shareholder meetings. The Gilberts were also long time advocates of enhancing director accountability through the elimination of staggered boards, director ownership of stock, and limits on executive compensation. Over the years following the adoption of the federal proxy rules, the Gilberts would introduce hundreds of shareholder proposals, and studies show that they were responsible for over half of all proposals introduced by retail investors. Their activism, including regular attendance at annual meetings, continued for almost seventy years until John Gilbert's death in 2002.[18]

B. THE TRANSAMERICA DECISION

The Transamerica case[19] resulted from a classic example of the Gilberts' shareholder activism. John Gilbert owned seventeen shares of Transamerica stock. Prior to the annual meeting, Gilbert advised Transamerica, as per the SEC rules, that he intended to introduce four proposals at the 1946 annual meeting: 1) to change the location of the annual meeting;[20] 2) to have independent public auditors of the company, to be elected by the shareholders; 3) to eliminate an existing bylaw, bylaw 47; and 4) to require that a report of the proceedings of the annual meeting be sent to all shareholders. These proposals were comparable to those introduced by the Gilbert brothers at many companies during this time period.

Transamerica's Bylaw 47, the subject of one of Gilbert's proposals, appeared to present an obstacle to Gilbert's plan. Bylaw 47 required notice of any bylaw amendments to be contained in the notice of the annual meeting—a document that was prepared and distributed by management. Transamerica argued that the board of directors had the

16. Sec. Exch. Act. Rel No. 3347, 1949 WL 35734 (Dec. 18, 1942).

17. See John Bainbridge, Profiles, The Talking Stockholder—I, The New Yorker, Dec. 11, 1948 at 40 (profiling Lewis Gilbert and describing his brother John).

18. See Davis Global Advisors, Inc., In Memory, Global Proxywatch, Volume 6, p. 2, July 26, 2002, http://web.management.mcgill.ca/Art.Durnev/proxy.pdf (reporting John Gilbert's death).

19. SEC v. Transamerica Corp., 163 F.2d 511 (3d Cir. 1947).

20. This proposal became moot prior to the litigation. Id. at 513, n 1.

discretion to decide what was contained in the notice of the annual meeting and that the board could therefore exclude Gilbert's proposals from that notice. Since Gilbert's proposals did not comply with Bylaw 47, they were not, according to Transamerica, permissible subjects for a shareholder vote under Delaware law.

The SEC advised Transamerica that it was required to include Gilbert's proposals in its proxy statement; when Transamerica refused, the SEC brought suit. The district court largely agreed with Transamerica.[21] The court determined that Transamerica was entitled to exclude Gilbert's proposals if they were not proper subjects for a shareholder vote, and that state law—in this case Delaware law—governed the issue of what constituted a proper subject for a shareholder vote. With respect to the annual meeting report, the court found that Gilbert's proposal was barred by Delaware law, which gives the directors authority over the business and operations of the corporation; the court concluded that the decision to provide such a report was therefore within the directors' discretion.

Turning to Bylaw 47, the court stated that the bylaw was valid and that Delaware law authorized the directors to act as gatekeepers with respect to issues to be considered at the annual meeting. The court explicitly found that, under Delaware law, the shareholders did not possess an absolute right to amend the bylaws. The court then rejected the SEC's argument that such a bylaw improperly deprived shareholders of their state law power to amend the bylaws, holding that this power was adequately preserved through an alternative mechanism consistent with Delaware law—a special meeting which the corporation was required to hold upon the request of a majority of the shareholders.

Finally, the district court concluded that Gilbert's resolution regarding the shareholder election of auditors was not barred by Bylaw 47 because it had not been explicitly framed as a bylaw amendment. As a resolution, the proposal was, according to the court, a proper subject for a shareholder vote, both because it did not conflict with any provision in Transamerica's bylaws or charters, and because the Delaware statute did not reserve the selection of the auditors to the directors. Moreover, as the court explained: "The matter of independent auditors is therefore of such fundamental importance that it should be considered and passed upon by stockholders themselves at a meeting and is not such a matter which it may be said the stockholders have already delegated to others."[22]

Both sides appealed to the Third Circuit Court of Appeals. Unlike the district court, the Third Circuit gave almost no consideration to the scope of shareholder voting rights under Delaware state law beyond recognizing the fact that shareholders had the power to amend corporate bylaws. The Court of Appeals did not even consider the possibility that the board's statutory authority over corporate operations could limit the

21. SEC v. Transamerica Corp., 67 F. Supp. 326 (D. Del. 1946).

22. 67 F. Supp. at 335.

permissible scope of shareholder voting power. Rather, in determining what constituted a proper subject for shareholder action under Rule X–14A–7, the court appeared to apply federal, rather than state law.

Not only did the court find that subjects of the Gilbert proposals to be proper, it also concluded that any issuer-specific limitations on the shareholder voting power conferred by that rule were improper.[23] The court's rationale was that such limitations would interfere with the intent of Congress to require fair corporate suffrage. In particular, the court concluded Congress intended shareholder voting rights to operate as a check on the abuse of power by corporate management, and that SEC rule X–14A–7 was consistent with that intention. As the court stated: "The power conferred upon the Commission by Congress cannot be frustrated by a corporate by-law."[24]

Importantly, the Transamerica decision is not based on state law authority about the allocation of power between shareholders and directors. Shareholder voting rights are, after all, the product of state law. State corporation statutes determine shareholder voting rights in the first instance, but typically they expressly require a shareholder vote only on a few critical issues such as the election of directors, mergers, charter amendments and dissolution. The statutes do not prohibit shareholders from voting on other issues, but neither do they explicitly permit it. Indeed, state law does not expressly give shareholders the right to introduce and vote on a shareholder resolution. In addition, shareholder voting rights are state-specific. In Delaware, for example, shareholder have the power to amend the bylaws, and that power cannot be eliminated.[25] In Indiana and Oklahoma, in contrast, only the board of directors has the power to amend the bylaws unless the charter confers that power on the shareholders.[26]

In addition, the statutes expressly contemplate issuer-specific tailoring of shareholder voting rights through the corporation's internal documents: the charter and bylaws. Nothing in state corporation statutes precludes corporations from adopting procedural rules concerning the exercise of shareholder voting rights—notice requirements, required holding periods or minimum holdings for the exercise of particular rights. Similarly, state law authorizes issuer-specific rules governing shareholder voting power. Delaware law, for example, authorizes corporations to adopt supermajority voting requirements,[27] to provide for the election of directors either by plurality or majority voting,[28] and to

23. In particular, as the court noted, Transamerica subsequently amended Bylaw 47 to require notice of shareholder-proposed bylaw amendments submitted by holders of 1% of the outstanding stock. The court concluded that this requirement was unduly onerous because it would have required approximately 1500 average shareholders to band together to request a vote on a bylaw amendment. 163 F.2d at 513 n.2. The court cited no state law authority for this conclusion.

24. 163 F.2d at 518.

25. 8 Del. C. § 109(a).

26. Indiana: 23–1–39–1; Oklahoma: § 1013.

27. 8 Del. C. § 102(b)(4).

28. 8 Del. C. §§ 141, 216 (amended 2006).

dispense with an annual meeting by electing directors by written consents.[29]

Nor is the Transamerica decision based on state decisional law. Concededly several recent Delaware decisions have emphasized the importance of shareholder voting and subjected board interference with the shareholder franchise to a higher level of judicial scrutiny.[30] However, the Transamerica decision predates these cases by many years. More importantly, the decision explicitly references congressional rather than state policy regarding the importance of shareholder voting.

The court's decision in Transamerica thus staked out the role of federal law in determining the scope of shareholder voting rights and the role of the federal government in enforcing those rights. The court stated that congressional intent in regulating proxy solicitation was not limited to disclosure: "It was the intent of Congress to require fair opportunity for the operation of corporate suffrage."[31] Moreover, the Transamerica decision established the authority of the SEC, both in dictating mechanisms to protect shareholder voting rights and in imposing its view of fair corporate suffrage upon issuers.

Importantly, the Transamerica decision also had the effect of partially displacing state courts in the lawmaking process. In the Transamerica case specifically, Bylaw 47 limited shareholder's statutory power to amend the bylaws. The validity of Bylaw 47 was based upon the extent to which this limitation was permissible, but that question was a matter of Delaware law. One would expect this type of question to be decided, in the first instance, by the Delaware Chancery court. Even if the Transamerica bylaw inappropriately thwarted shareholders' voting rights, one obvious alternative to the Third Circuit's federalization of this question was for Gilbert to challenge the validity of the bylaw in state court.

C. FURTHER DEVELOPMENT OF THE FEDERAL PROXY RULES

The Transamerica decision represented the high point in SEC protection of shareholder voting. Rule X–14A–7 afforded shareholders the broadest power with respect to the introduction of shareholder proposals; it imposed no qualification requirements, limits on the number of proposals allowed, or subject matter limits. Within a few years, however, the SEC began to limit the scope of the shareholder proposal rule. In addition, Transamerica is the only case in which the SEC brought suit to compel an issuer to include a shareholder proposal.[32]

29. 8 Del. C. § 228.

30. See, e.g., Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 660–62 (Del. Ch. 1988); see also Schnell v. Chris–Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971).

31. 163 F.2d at 518.

32. Indeed, the SEC gradually moved from a defender of shareholder voting rights to a defender of issuer efforts to exclude shareholder proposals. See Medical Comm. for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970), vacated as moot, 404 U.S. 403 (1972), (in which the SEC issued a

Subsequent to the Transamerica case, the SEC gradually began to retreat from its expansive view of the appropriate scope of shareholder voting power.

Following the Transamerica decision, use of the shareholder proposal rule slowly but gradually increased. Published statistics showed that shareholder proposals were introduced at large and well-known companies, yet their use was relatively rare in the 1940s and 50s. One study reported that during the period 1945–57 (pre-Transamerica), 1.4% of proxy statements submitted to the SEC contained shareholder proposals.[33] By 1955 that number had risen to 3.1%.[34] The Gilbert brothers were responsible for approximately half the shareholder proposals submitted during this time period; in 1955, they submitted 65% of all proposals.[35] The shareholder proposals dealt primarily with corporate governance issues. Cumulative voting, selection of auditors, elimination of staggered boards and executive compensation were the most popular issues.[36]

In addition, the SEC began the process of refining the shareholder proposal rule, a process that has continued to the present day. Through half a dozen amendments to the federal proxy rules, the SEC introduced advance notice requirements, limits on the number of words and the number of proposals, qualification requirements for proposing shareholders, and limitations on resubmission of previously-submitted proposals. In addition, in response to uses of shareholder proposal that it viewed as inappropriate, the SEC moved from the broad concept of proper subject matter it had advocated in the Transamerica decision to a rule that articulated a growing number of bases on which management was permitted to exclude a shareholder proposal as improper. These bases included proposals made "primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes," proposals that addressed the "conduct of the ordinary business operations of the issuer," proposals relating to director elections and proposals concerning specific amounts of dividend payments.

In 1976, the SEC also formally created the so-called precatory proposal.[37] Having determined that shareholder proposals which took the form of a directive or mandate could create a tension with state statutes giving boards exclusive authority over corporate decision-making,[38] the SEC decided that this problem could generally be addressed by framing

no-action letter permitting issuer to exclude shareholder proposal).

33. Frank D. Emerson & Franklin C. Latcham, The Sec Proxy Proposal Rule: The Corporate Gadfly, 19 U. Chi. L. Rev. 807, 812 (1951–1952).

34. Frank D. Emerson, Some Sociological and Legal Aspects of Institutional and Individual Participation Under the SEC's Shareholder Proposal Rule, 34 U. Det. L.J. 518, 537 (1957).

35. Id. at 542.

36. Id. (describing statistical breakdown of shareholder proposals by subject matter).

37. Adoption of Amendments Relating to Proposals by Security Holders, Sec. Exch. Act Rel. No. 12999, 1955 WL 5976 (Nov. 22, 1976).

38. Indeed, such a provision in the Delaware statute had led the district court in Transamerica to conclude that the request for an annual meeting report was not a proper subject for shareholder action. Transamerica, 67 F.Supp. at 330.

the proposal as a request or recommendation rather than a mandate. Concededly there was state law authority that shareholders lacked the power to interfere with certain types of corporate decisions.[39] It is not clear, however, that this authority operated as a limitation on shareholder voting power—conceivably shareholders were free to pass resolutions or bylaw amendments subject to a subsequent judicial determination as to the validity of those resolutions or the extent to which management was required to comply with them. Nonetheless, the SEC reasoned that it would be illogical to allow shareholders to vote on actions that they lacked the power to take. Accordingly, it added a note to the rule stating that, "A proposal that may be improper under the applicable state law when framed as a mandate or directive may be proper when framed as a recommendation or request."[40] Interestingly, and somewhat ironically, there is no explicit authority in state law empowering shareholders to vote on precatory resolutions. Thus, in the guise of ensuring that shareholder voting did not conflict with state law, the SEC granted shareholders voting rights that arguably extended beyond those afforded by state law, although the significance of the rights was somewhat limited.

The bases for exclusion were interpreted and applied by the SEC staff through the no-action process.[41] The no-action process is an informal and non-binding adjudication that results from the requirement in Rule 14a–8 that issuers notify the SEC if they intend to exclude a shareholder proposal. An issuer that seeks to exclude a proposal submits to the staff an explanation of the bases upon which exclusion can be justified and requests that the SEC take no enforcement action against it if the proposal is excluded. The staff responds by advising the issuer whether it agrees. If the staff agrees, the proposal is excluded. If the staff states that, in its opinion, the proposal cannot be excluded, the issuer generally acquiesces.

Staff decisions are not binding upon the courts, which may compel that a proposal be included despite the staff position. In addition, the letters have no precedential value. Nonetheless, as the D.C. Circuit recognized in *Medical Committee for Human Rights*,[42] shareholders rarely pursue litigation if the staff issues a no action letter, as a result, the SEC staff position essentially becomes the law unless or until the Commission itself overturns it or announces a formal change in policy. From time to time the SEC does issue a more formal interpretation of

39. See, e.g., Charlestown Boot & Shoe Co. v. Dunsmore, 60 N.H. 85(1880) (rejecting efforts by shareholders to control directors' exercise of their power to run the corporation).

40. See Adoption of Amendments, 1976 WL 160347 (explaining rationale for addition of this note).

41. See Statement of Informal Procedures for the Rendering of Staff Advice with Respect to Shareholder Proposals, Sec. Exch. Act Rel. No. 12599, 1976 WL 160411 (July 7, 1976) (describing evolution of no-action process with respect to shareholder proposals).

42. See Medical Comm. for Human Rights, 432 F.2d at 672 ("For the small investor, personal recourse to the Commission's proxy procedures without benefit of counsel may well be the only practicable method of contesting a management decision to exclude his proxy proposal").

the rules in the form of an interpretive release, which is designed to provide broader guidance than the no-action process. Some of the SEC's releases with respect to Rule 14a–8 are discussed in more detail below.

The no-action process has, from time to time, produced some controversy on the question of what constitutes a proper subject for shareholder action. One example is the exclusion for social, religious, political and similar proposals. In 1969, the Medical Committee for Human Rights, owner of five shares of Dow Chemical stock, submitted a shareholder proposal that requested Dow to take steps to restrict the manufacture and sale of napalm. Dow refused to include the proposal, arguing that it was excludable both as "primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes"[43] and as "relating to the conduct of the ordinary business operations of the issuer."[44] The SEC staff, which had shifted its approach to shareholder proposals substantially from the bastion of shareholder sovereignty reflected in the Transamerica litigation, issued a no-action letter advising Dow that it could exclude the proposal. The Medical Committee appealed to the SEC, which affirmed the staff decision.[45]

The Medical Committee then challenged the SEC's determination in the Court of Appeals, which held that the SEC's decision lacked an adequate basis and remanded, stating that the SEC's interpretation of its rule was inconsistent with the congressional intent behind section 14(a). The court stated that: "Our own examination of the issue raises substantial questions as to whether an interpretation of Rule 14a–8(c)(2) which permitted omission of this proposal as one motivated primarily by general political or social concerns would conflict with the congressional intent underlying Section 14(a) of the Act."[46] The court noted that the manufacture of napalm was economically significant to the company and had also subjected Dow to controversy.[47] In addition, the court explicitly distinguished the proposal at issue from questions of general social policy that are beyond management's control: "the proposal relates solely to a matter that is completely within the accepted sphere of corporate activity and control."[48]

At roughly the same time, the Project on Corporate Responsibility, a shareholder group, was waging a proxy contest at General Motors called Campaign GM.[49] The shareholders introduced nine proposals on a variety of issues, including the appointment of public interest directors to the board, and proposals to address air pollution and employee safety. The

43. The SEC adopted this exclusion following an unsuccessful effort by a shareholder to raise the issue of segregated seating through a shareholder proposal at Greyhound. Medical Committee for Human Rights, 432 F.2d at 678. See Peck v. Greyhound Corp., 97 F. Supp. 679 (S.D.N.Y. 1951) (deferring to the SEC's decision that the proposal could be excluded).

44. Medical Committee for Human Rights, 432 F.2d at 676, 679.

45. See SEC v. Medical Committee for Human Rights, 404 U.S. 403, 404 (1972) (describing procedural history).

46. Id. at 680.

47. Id. at 681.

48. Id.

49. See Jill E. Fisch, From Legitimacy to Logic: Reconstructing Proxy Regulation, 46 Vand. L. Rev. 1129, 1154 (1993) (describing Campaign GM).

SEC required General Motors to include two of these proposals in its proxy statement, but allowed the company to exclude the others with little explanation.

Congress considered a legislative response. In 1970, Senator Edmund Muskie introduced the Corporate Participation Bill.[50] The bill was designed to overrule SEC restrictions on social policy proposals by allowing shareholders to introduce proposals aimed at advancing "the general welfare." When the Supreme Court dismissed the Medical Committee for Human Rights case as moot, because Dow had included the proposal and it failed to command the 3% vote necessary for resubmission, Justice Douglas wrote in dissent that Senator Muskie's bill reflected "substantial sentiment" for a more liberal approach to the use of shareholder proposals.[51] Shortly thereafter, the SEC amended rule 14a–8 to provide that social policy proposals could only be excluded if they were "not significantly related to the business of the issuer or is not within the control of the issuer." Although at first blush this amendment appeared to increase the issuer's power to exclude social policy proposals[52] (See Douglas opinion at 410 n.6), staff interpretations (perhaps influenced by the statements by the Second Circuit and members of Congress) came to reflect an increasingly liberal approach to social policy proposals. As a result, in the following years, shareholder proposals on social, religious and political issues became commonplace, and religious and political groups came to dominate the shareholder proposal process.

Another issue concerned the use of shareholder proposals to address executive compensation. Starting in the late 1970s, executive compensation, and CEO pay in particular, began to escalate.[53] The process increased in the 1980s, presumably in response to substantial cuts in the maximum income tax rate. Pay increased in absolute terms, as a multiple of average worker pay, and in comparison to executive compensation in other countries. Companies developed new forms of compensation such as guaranteed bonuses, golden parachutes, and compensation to cover tax liabilities.

The increases generated substantial controversy. Congress responded through a variety of efforts, largely unsuccessful, to create tax penalties for excessive executive compensation.[54] The SEC responded by increasing required disclosure of executive compensation. Shareholder activists called for limits on pay and greater ties to performance. Despite legislative, regulatory and media attention, however, the SEC staff took the position that shareholder proposals relating to executive compensa-

50. S. 4003, § 2, 91st Cong., 2d Sess.

51. SEC v. Medical Committee for Human Rights, 404 U.S. 403, 410 (1972) (Douglas, J., dissenting).

52. See id. at 410 n.6 (stating that the SEC's proposed rules "might strengthen Dow's hand").

53. See generally Lucian Bebchuk & Jesse Fried, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (describing growth in executive compensation and development of various compensation forms).

54. "The Bill Agee Bill," adopted in 1984, imposed a special tax on golden parachutes. Internal Revenue Code section 162(m), adopted in 1993, limited the deductibility of non-performance based executive compensation of over $1 million/year.

tion dealt with ordinary business issues and could therefore be excluded under Rule 14a–8(c)(7).[55] As Senator Levin explained, "The policies of the SEC place a major roadblock in the way of stockholders having a say in how CEO pay is set within their own corporation."[56] The SEC did not reverse this position until 1992.[57] As the staff explained: "In view of the widespread public debate concerning executive and director compensation policies and practices, and the increasing recognition that these issues raise significant policy issues, it is the Division's view that proposals relating to senior executive compensation no longer can be considered matters relating to a registrant's ordinary business."[58]

The SEC's change in policy addressed compensation, but not the broader question of employment related policies. The staff continued to permit the exclusion of many proposals dealing with employment as relating to ordinary business operations, adopting a case-by-case approach in which it attempted to evaluate the extent to which the proposal raised significant social policy concerns. In 1992, New York City Employees' Retirement System (NYCERS), an institutional investor, submitted a proposal to Cracker Barrel requesting that the board implement hiring policies that barred discrimination on the basis of sexual orientation.[59] Not only did the staff permit Cracker Barrel to exclude the proposal, it announced a new blanket prohibition on employment related proposals. Explaining that "the line between includable and excludable employment-related proposals based on social policy considerations has become increasingly difficult to draw," the staff stated that henceforth, social policy concerns would not have the effect of removing the proposal

55. See, e.g., Transamerica Corp., SEC No–Action Letter, 1990 WL 285806 (Jan. 10, 1990) (stating that "the Division's existing position regarding proposals dealing with compensation arrangements is that such matters relate to the conduct of a registrant's ordinary business operations and may be excluded pursuant to rule 14a–8(c)(7)"). The SEC had taken this position since it added the exclusion for proposals relating to ordinary business operations in 1954. Solicitation of Proxies, Exchange Act Release No. 4979 (Jan. 5, 1954). The SEC immediately interpreted this provision to allow exclusion of shareholder proposals dealing with employment compensation. See Edward Aranow & Herbert Einhorn, Proxy Contests for Corporate Control 293 (2d ed. 1968) (observing that SEC permitted ATT to exclude shareholder proposal regarding employee benefits as "ordinary business operations."); see also Curtin v. American Tel. & Tel. Co., 124 F. Supp. 197, 198 (S.D.N.Y. 1954) (deferring to the SEC's determination that pensions are "matters that primarily are the responsibility and concern of the corporate management and its directors rather than that of its stockholders"). Ironically, the SEC originally took the position that shareholder proposals regarding executive compensation were proper, and early shareholder activists like the Gilberts frequently introduced such proposals. See Emerson & Latcham, supra note 33, 19 U. Chi. L. Rev. at 821–25 (describing shareholder proposals on executive compensation during the 1948–51 proxy seasons).

56. Runaway Executive Pay, 138 Cong Rec § 214 (1992).

57. See Executive Compensation Disclosure, Exchange Act Release No. 30,851, 1992 WL 151039 (June 23, 1992) (describing the SEC's reversal in position and listing companies for which the SEC required inclusion of proposals on executive compensation).

58. Reebok Int'l Ltd., SEC No–Action Letter, 1992 WL 55815 (Mar. 16, 1992).

59. Cracker Barrel Old Country Store, Inc., 1992 WL 289095 (Oct. 13, 1992). The proposal requested the Cracker Barrel board to "1) implement nondiscriminatory policies related to sexual orientation, and 2) add explicit prohibitions against such discrimination to the Company employment policy statement." Letter Inquiry dated July 13, 1992, Fed. Sec. L. Rep. at 77,285.

from the realm of ordinary business operations. "Rather, determinations with respect to any such proposals are properly governed by the employment-based nature of the proposal." The SEC affirmed the staff position. NYCERS challenged the SEC's decision in court, arguing that the SEC's change in position violated the Administrative Procedure Act, but the Second Circuit refused to issue an injunction, concluding that the no-action letter was simply "interpretive and non-binding" and therefore was not subject to the procedural requirements of a formal legislative rule.

The SEC's change generated extensive public outcry. One reason, as demonstrated in the Cracker Barrel dispute itself, was that institutional investors had become a growing force in corporate governance and the shareholder proposal process. Institutions–public pension funds, union funds, mutual funds, insurance companies, university endowments, foundations and others–owned an increasing percentage of the market and had begun to make active use of rule 14a–8. Institutional presence significantly affected the shareholder proposal process. Indeed, virtually no shareholder proposals had ever received majority approval until 1988,[60] when a CalPERS sponsored proposal at Gillette to prohibit greenmail[61] received 53% approval.[62] There were several reasons for this lack of success. First, although rule 14a–8 reduces the cost of submitting a shareholder proposal, since the proposal is distributed as part of the company's proxy materials, the costs of any proxy solicitation are borne personally by the sponsoring shareholder. These costs can be substantial–the average cost of a proxy contest ranges from $250,000 to $1 million.[63] Few investors have the type of financial or other interest in a shareholder proposal to justify this expenditure. Second, shareholder voting suffers from a collective action problem. Dispersed investors with relatively small stakes have little financial incentive to pay attention to the voting process, or even to vote. Third, the collective action problem is enhanced by the relative unimportance of shareholder voting. As indicated above, the economic significance of most shareholder proposals is reduced by their precatory nature, and as described in further detail below, very few director elections involve an election contest. As a result, shareholders can rationally conclude that, in the vast majority of cases, their votes do not matter.

60. See, e.g., George W. Dent, Jr., SEC Rule 14a–8: A Study in Regulatory Failure, 30 N.Y.L. SCH. L. REV. 1,7 (1985) (stating that "no shareholder proposal opposed by management has ever come close to receiving approval of a shareholder majority"); but see Susan W. Liebeler, A Proposal to Rescind the Shareholder Proposal Rule, 18 GA. L. REV. 425, 426 (1984) (stating that, according to the SEC staff, as of 1981 only two shareholder-sponsored proposals had been approved).

61. "The term 'greenmail' refers to the practice of buying out a takeover bidder's stock at a premium that is not available to other shareholders in order to prevent the takeover." Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 956 n.13 (Del. 1985).

62. CALIF-PUBLIC–EMP; California Public Employees' Retirement System wins approval of Gillette Co. shareholder proposal Business Wire May 3, 1988.

63. William W. Bratton, Hedge Funds and Governance Targets, working paper at 30 (2006), Georgetown Law and Economics Research Paper No. 928689, available at: http://ssrn.com/abstract=928689.

By the early 1990s, institutional investors, particularly pension funds and unions, had begun to sponsor shareholder proposals regularly. Empirical studies showed that shareholder proposals sponsored by institutional investors, which tended to focus on corporate governance, received greater shareholder support than other proposals and were more likely to be approved.[64] Institutional activism was also leading institutional investors to pay greater attention to their voting rights, which contributed to the new success of shareholder proposals.[65]

Employment related proposals were of particular interest to public pension funds and union funds. Fearing the impact of the Cracker Barrel rule, a number of high-profile institutional investors petitioned the SEC to overturn its decision.[66] Institutional pressure was supplemented by congressional pressure. As part of the National Securities Markets Improvement Act of 1996, Congress required the SEC to conduct a comprehensive study of the shareholder proposal process to determine whether shareholders had adequate access to proxy statements and whether such access had been "impaired by recent statutory, judicial, or regulatory changes."[67] The SEC responded by soliciting input from issuers, shareholders and other market participants and was flooded with responses critical of the existing application of the shareholder proposal rule.[68]

Finally, in 1998, as part of another set of revisions to the proxy rules, the Commission reversed its decision in Cracker Barrel.[69] The SEC's release indicated that the SEC was returning to its prior approach of evaluating employment related proposals on a case by case basis. In addition, the SEC explicitly reinstated its prior position that employment-related issues are proper subjects for shareholder proposals so long as they raise "substantial policy or other considerations."[70]

More recently, the SEC has struggled with shareholder voting over poison pills. Institutional investors have generally opposed the adoption of poison pills, staggered boards, and other antitakeover devices that allow management to resist a tender offer despite shareholder opposi-

64. Stuart L. Gillan & Laura T. Starks, 1998, Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors, 57 J. Fin. Econ. 275 (2000).

65. Institutional attention to the voting process was enhanced by the SEC's adoption of Investment Company Act Rule 30b1–4 2003, requiring required mutual funds to disclose their proxy voting policies and voting records. See SEC Press Release, Securities and Exchange Commission Requires Proxy Voting Policies, Disclosure by Investment Companies and Investment Advisers, Jan. 23, 2003, available at http://www.sec.gov/news/press/2003–12.htm (describing disclosure requirement).

66. 1997 Proposed Amendments, supra note 55, at 50,683 n.15 (stating that a number of institutional investors including the Interfaith Center on Corporate Responsibility, the Calvert Group Ltd., and the Comptroller of the City of New York requested that Cracker Barrel be overturned).

67. National Securities Markets Improvement Act of 1996, Pub. L. No. 104–290, 510(b)(1), 110 Stat. 3416, 3450.

68. See Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 39,093, 62 Fed. Reg. 50,682 (Sept. 26, 1997) (describing the SEC's efforts to obtain information from market participants and resulting comments).

69. Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 34–40018, 63 Fed. Reg. 29,107 (1998).

70. 63 Fed. Reg. at 29108.

tion. Beginning in the late 1980s, institutional investors began to introduce shareholder proposals seeking to limit director authority to adopt or maintain poison pills. Initially many of these proposals were precatory and simply requested that the board take action such as repealing the company's poison pill.[71] The SEC generally required issuers to include these proposals. Many corporate boards, however, simply ignored the proposals, even when they received majority approval.[72] As a result, by the late 1990s, shareholders had begun to submit binding proposals to eliminate poison pills, typically in the form of proposed bylaw amendments.[73]

Poison pill bylaws raise the broader question about the permissible scope of shareholder-adopted bylaws and the extent to which shareholders, through bylaw provisions, can limit director discretion. As many commentators have noted, such proposals create a conflict between the shareholders' statutory power to amend the bylaws and the boards' statutory authority to run the corporation.[74] The conflict has not been fully resolved by the state courts which have not been called upon to determine the permissible scope of the shareholders' power to limit director authority through the bylaws. In part, judicial resolution of this question has been frustrated by the SEC's preference for precatory proposals because, in the view of the Delaware courts, unless and until a binding proposal in the form of a bylaw amendment is submitted, voted upon and approved by a majority of the shareholders, a judicial determination of its validity is not ripe.[75]

The most extensive consideration of poison pill bylaws took place in Oklahoma. The Teamsters submitted a precatory shareholder proposal to the Fleming Companies in 1996, requesting that the board redeem the company's poison pill.[76] The proposal was approved by a majority of the shareholders, but the board ignored it and failed to redeem the pill. The following year, the Teamsters resubmitted its proposal, this time in the form of a binding bylaw amendment providing that the company could not adopt or maintain a poison pill without approval by a majority of the shareholders. Fleming refused to include the proposal in its 1997 proxy statement, arguing that the proposal was not a proper subject for a

71. See, e.g., Dale Arthur Oesterle, Revisiting the Anti–Takeover Fervor of the '80s through the Letters of Warren Buffet: Current Acquisition Practice is Clogged by Legal Flotsam from the Decade, 19 Cardozo L. Rev. 565, 603 (1997) (reporting substantial number of precatory shareholder proposals recommending that board redeem a poison pill received majority support).

72. Id.

73. See Brett H. McDonnell, Shareholder Bylaws, Shareholder Nominations, and Poison Pills, 3 Berkeley Bus. L.J. 205, 254 (2005) (describing how "the weak effect of precatory proposals" led to shareholder efforts to introduce poison pill bylaw amendments).

74. See, e.g., id.; Lawrence A. Hamermesh, Corporate Democracy and Stockholder–Adopted By–Laws: Taking Back the Street?, 73 Tul. L. Rev. 409 (1998).

75. See, e.g., General Datacomm Industries, Inc. v. State of Wisconsin Investment Board, 731 A.2d 818, 818 (Del. Ch. 1999) (refusing to decide validity of proposed bylaw because the issues were "not yet ripe for judicial resolution ").

76. International Bhd. of Teamsters Gen. Fund v. Fleming Cos., 1999 OK 3, 975 P.2d 907, 914 (Ok. Sup. 1999).

shareholder vote under Oklahoma law. The Teamsters then brought suit, in federal district court, to compel Fleming to include the proposal.[77]

The district court summarily issued an order ordering Fleming to include the Teamsters proposal, and Fleming did so. The proposal was included in Fleming's 1997 proxy statement and received the approval of approximately 60% of the shareholders. Fleming appealed to the Tenth Circuit, which certified to the Oklahoma Supreme Court the question of whether the Teamsters' bylaw was valid. The Oklahoma court held that it was, finding nothing in the Oklahoma statute that "indicates the shareholder rights plan is somehow exempt from shareholder adopted bylaws."[78]

Although, it lost in court, ultimately Fleming prevailed. In 2001, the Oklahoma legislature amended the corporation statute, in response to the Fleming decision, to eliminate shareholder power to amend the bylaws.[79] Oklahoma is now one of a small majority of states in which the directors have the exclusive authority to amend the bylaws. Thus the Fleming case is notable not simply for its narrow ruling on the permissibility of poison pills bylaws, but also for its revelations about the respective roles of the states and the federal government in the protection of shareholder voting rights. The Fleming case is virtually unique in allowing a state court to make the determination of whether a shareholder proposal constituted a proper subject for a shareholder vote. At the same time, the Oklahoma legislature's response—eliminating the judicially recognized shareholder voting power—offers some support for the Transamerica court's view that a broad recognition of federally protected voting rights is necessary to achieve congressional intent under section 14(a), and that Congress's intent to ensure fair corporate suffrage should not be frustrated even by means that are permissible under state law.

As the foregoing examples illustrate, the determination, for purposes of rule 14a–8, of what constitutes a proper subject for shareholder action, has been difficult. In the vast majority of these cases, the determination has been made by the SEC staff. Although the staff's determination can been reviewed and overturned, either by the Commission itself or by the courts, such review is rare. Moreover, the structure of the no-action process has the effect of largely preventing state courts from having the opportunity to consider the question of what constitutes a proper subject for shareholder voting, despite the fact that the answer to this question is based in state corporation law, not the federal proxy rules. The recent Fleming case, although exceptional in allowing this role to the state

77. International Bhd. of Teamsters Gen. Fund v. Fleming Cos., No. Civ. 96–1650–A, 1997 U.S. Dist. LEXIS 2980, at *1 (W.D. Okla. Jan. 24, 1997). Fleming asked the SEC for a no-action letter, but the SEC refused to take a position in light of the pending litigation. Fleming Companies, Inc., 1996 WL 34432841 (Dec. 3, 1996).

78. International Bhd. of Teamsters Gen. Fund v. Fleming Cos., 1999 OK 3, 22, 975 P.2d 907, 914 (Ok. Sup. 1999).

79. Gary W. Derrick, New Developments in Oklahoma Business Entity Law, 56 Okla. L. Rev. 259, 265–67 (2003) (describing legislative response to Fleming decision).

court, highlights the importance both of better determining shareholders' state law voting rights and of directly confronting the question of whether federal law authorizes the SEC to expand or contract those rights.

D. THE FEDERALLY DELINEATED SHAREHOLDER RULE IN DIRECTOR ELECTIONS

The shareholder role in director elections has also been determined largely by federal law. Although state statutes empower shareholders to elect the directors, they are silent on shareholder rights with respect to the nomination process. Moreover, management control of the proxy machinery creates an uneven playing field. Although a dissident shareholder can nominate his or her own slate of directors and solicit proxies in favor of that slate, the costs of mounting a proxy contest are so large as to make an election challenge unavailable to the vast majority of shareholders.[80]

A federal rule, equivalent to the shareholder proposal rule, enabling shareholders to nominate candidates who would be included in the company's proxy statement would help to counteract management control. The SEC initially considered allowing shareholders to use the shareholder proposal rule to nominate directors. In 1942, the SEC solicited comments on a staff proposal that would have provided that "minority stockholders be given an opportunity to use the management's proxy material in support of their own nominees for directorships."[81] The proposal was not adopted.[82] According to some commentators, the decision was based on unfavorable congressional and public reaction.[83]

Shortly thereafter, the SEC staff began issuing interpretations that shareholders could not use rule 14a–8 to nominate director candidates. Subsequently, the SEC formally amended the text of the Rule to exclude proposals relating to director elections.[84] Initially, the staff interpreted this exclusion somewhat narrowly, concluding that while shareholders could not nominate directors or oppose management candidates through

80. See generally Lucian A. Bebchuk & Marcel Kahan, A Framework for Analyzing Legal Policy Toward Proxy Contests, 78 Cal. L. Rev. 1071 (1990) (advocating state law changes that would address this problem).

81. See Division of Corporation Finance, Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, July 15, 2003, available at http://www.sec.gov/news/studies/proxyreport.pdf (describing history of direct nomination proposal).

82. In the 1942 proxy rule amendments, the Commission stated, without explanation, that it was not adopting the proposal. Exch. Act. Rel No. 3347, 1942 WL 34864 (Dec. 18, 1942).

83. See Security and Exchange Commission Proxy Rules: Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 Before the House Comm. on Interstate and Foreign Commerce, 78th Cong., 1st Sess. (1943) (recounting SEC decision).

84. See Adoption of Revised Proxy Rules, Exchange Act Release No. 4037, 1947 WL 24687 (Dec. 17, 1947). Rule X–14A–8(a) included the sentence "This rule does not apply, however, to elections to office." See Amendment of Proxy Rules, Sec. Exch. Act Rel. No. 4775, 1952 WL 5254 (Dec. 11, 1952) (setting forth text of Rule X–14A–8(a)).

the shareholder proposal process, the exclusion did not bar proposals relating to the election process itself, such as proposals for cumulative voting or seeking to implement general qualifications for directors.[85] This position was clarified when the SEC adopted the current version of the exclusion in 1976, which provides an issuer can exclude a proposal that "relates to an election for office."[86] The SEC adhered to the narrow interpretation of the election exclusion for approximately sixteen years.[87] The SEC revisited the subject of shareholder nominations during this time period; it conducted an extensive study in 1977, which was followed by hearings in four cities.[88] The hearings focused specifically on a proposed rule change that would have enabled shareholders to nominate director candidates directly. The subject proved extremely controversial and, faced with strong opposition from corporations and managers, the SEC failed to amend its rule, deferring to increased issuer use of nominating committees.[89]

In 1990, however, the staff began to interpret the election provision more broadly and began to allow issuers to exclude proposals that "might result in contested elections.[90] By 1998, the SEC was consistently excluding shareholder proposals that "might result in contested elections."[91] This had the effect of barring proposals that sought to impose director qualifications such as independence as well as preventing shareholders from amending corporate bylaws to provide for shareholder nominations.[92]

Institutional investors, who were becoming increasingly activist in the 1990s, were frustrated with the limitations imposed on shareholder voting power through the federal proxy rules.[93] In response to institutional pressure, the SEC conducted an extensive three year review of the

85. Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12,999, 1976 WL 160347 (Nov. 22, 1976) (explaining that Commission had previously held that proposals dealing with matters such as qualifications for directors and cumulative voting were not excludable on the basis that they related to an election for office).

86. Id. The adopting release specifically explained that the language of the exclusion was intended to clarify the SEC's continued adherence to its previous position that proposals dealing with matters such as cumulative voting rights, general qualifications for directors, and political contributions by the issuer" were not excludable.

87. AFSCME v. Am. Int'l Group, Inc., 462 F.3d 121, 128 (2d Cir. 2006).

88. SEC, Staff Report on Corporate Accountability: A Re-examination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Senate Comm. on Banking, Hous. & Urban Affairs, 96th Cong., 2d Sess. 98–127 (Comm. Print 1980).

89. Id.

90. AFSCME,, 462 F.3d at 128.

91. AFSCME, 462 F.3d at 128, n.7

92. See, e.g., Amoco Corp., SEC No-Action Letter, 1990 WL 286092 (Feb. 14, 1990) (allowing exclusion under Rule 14a-8(c) of a proposal to allow large shareholders to nominate director candidates on a common ballot with management).

93. See, e.g., Letter from Richard H. Koppes, CalPERS General Counsel, to Linda C. Quinn, Director, Division of Corporation Finance, Securities and Exchange Commission (Nov. 3, 1989); Coffee, 15 Cardozo L. Rev. 837, 907 n.9 (describing rulemaking petitions filed by United Shareholders Association and Fidelity Management & Research Co. in 1990 asking SEC to amend the federal proxy rules to remove these limitations).

federal proxy rules.[94] Following this review, the SEC amended the proxy rules in 1992 to remove some constraints on institutional activism as well as to permit investors to run short slate election contests.[95] The amendments did not, however, require issuers to include shareholder nominees on the company's proxy statement.

Shareholders' concerns about their limited input into the composition of corporate boards was heightened by the corporate misconduct scandals of the late 1990s. In 2002, the American Federation of State County and Municipal Employees ("AFSCME") developed a proposal by which shareholders owning at least 3% of a company's stock could nominate a short slate of directors. The proposal was submitted at six issuers in connection with their 2002 annual meetings, but the SEC permitted issuers to exclude the proposal on the grounds that it related to an election for office, and the SEC declined to review the staff's decisions.[96]

In response, the AFL–CIO petitioned the SEC to adopt a rule that would allow shareholder-nominated directors to appear on a company's proxy ballot.[97] The Commission directed the staff to review the federal proxy rules and, on October 23, 2003, the Commission proposed a direct access rule, largely modeled on the AFSCME proposal, that would enable shareholders, under limited circumstances, to have a minority slate of nominees included in the issuer's proxy statement.[98] As proposed, the SEC's rule would have allowed shareholders owning at least 5% of the company to nominate a minority slate of up to three director candidates upon the occurrence of a triggering condition. The triggering conditions were either a withhold vote of at least 35% for one of management's director candidates or shareholder approval of a proxy access proposal submitted by shareholders owning 1% of the company. The SEC indicated that it was also considering a third trigger–the refusal of the issuer to implement a shareholder proposal that had received approval by a majority of the shareholders. Because of the requirement of a triggering event, shareholder access at a particular company would require at least two years. The SEC held hearings and received letters of comment from 690 individuals and organizations.[99] The SEC did not adopt the rule, and

94. Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, 1992 WL 301258 (Oct. 16, 1992).

95. Id.

96. SEC Division of Corporation Finance, Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, July 15, 2003, at 1, available at http://www.sec.gov/news/studies/proxyreport.pdf.

97. AFL-CIO, Request for Rulemaking to Permit Shareholder–Nominated Director Candidates to Appear in Corporate Proxy Statements and Proxy Cards (May 15, 2003), at http://www.sec.gov/rules/petitions/petn4-491.htm (petitioning for "comprehensive new rules that will give shareholders equal access to the proxy for their director nominees").

98. Security Holder Direct Nominations, Exchange Act Release No. 48,626, 2003 WL 22350515 (Oct. 14, 2003).

99. Summary of Comments In Response to the Commission's Solicitation of Public Views Regarding Possible Changes to the Proxy Rules, Exchange Act Release No. 34–47778, Division of Corporation Finance Staff Report, Appendix A at 21, July 15, 2003, avail. at http://www.sec.gov/news/studies/proxycomsum.pdf.

media reports and commentators attributed the proposal's failure to political pressure and opposition by corporate representatives including the Business Roundtable and the Chamber of Commerce.[100]

In light of the SEC's failure to adopt a direct access rule, AFSCME resumed its efforts to modify the nomination process through a shareholder-adopted bylaw. In 2004, AFSCME submitted its director nomination bylaw to AIG for inclusion in the company's 2005 proxy statement. AIG sought a no-action letter from the SEC, which issued the requested letter advising AIG that the proposal could be excluded on the grounds that it related to an election.[101] AFSCME then brought suit in federal court seeking to compel AIG to include the proposal despite the SEC's position.[102] The district court agreed that the proposal could be excluded and AFSCME appealed. The SEC submitted an amicus brief, arguing that the proposal was properly excluded.[103] As with the Medical Committee for Human Rights case, once again, the SEC took a position in litigation supporting limits on shareholder voting rights, in an odd turnabout from its position in Transamerica. The Second Circuit rejected the SEC's argument, finding that the SEC's current characterization of the exclusion for proposals that relate to an election was inconsistent with the SEC's narrower 1976 interpretation of the rule. The court therefore ordered AIG to include the proposal.[104]

In May 2007, the SEC held a series of three roundtable discussions on shareholder voting rights and the federal proxy rules.[105] Although the subject of direct nomination was not formally on the agenda, Chairman Cox announced that the SEC was in the process of developing a proposal that would allow shareholder nominees to be included in the issuer's proxy statement.[106] On July 25, 2007, the SEC approved two alternative rulemaking proposals. The first alternative proposed overruling the AFSCME decision and codifying the SEC's interpretation that proxy access proposals are excludable under Rule 14a–8.[107] The alternative proposed permitting proxy access proposals under limited circumstances.[108] In order to qualify, a proposing shareholder or shareholder group would have to own at least 5% of the company's stock for at least a year and have filed a schedule 13G, and the proposal would have to take the form of a binding amendment to the company's bylaws. The proposed rule also required increased disclosure about the proponent and

100. See, e.g., Ron Orol, Daily Deal/The Deal July 2, 2004 (attributing SEC's failure to adopt rule to opposition by Chamber of Commerce and Business Roundtable).

101. SEC No–Action Letter 2005 WL 372266 (Feb. 14, 2005).

102. AFSCME v. Am. Int'l Group, Inc., 361 F. Supp. 2d 344 (S.D.N.Y. 2005).

103. See AFSCME, 462 F.3d at 126 n.5 (describing filing by SEC of amicus brief).

104. AFSCME v. Am. Int'l Group, Inc., 462 F.3d 121 (2d Cir. 2006).

105. SEC Announces Roundtable Discussions Regarding Proxy Process, Press Release, Apr. 24, 2007, avail. at http://www.sec.gov/news/press/2007/2007–71.htm.

106. Roy Harris, Letting Investors Play the Proxy Game CFO.com May 8, 2007.

107. Shareholder Proposals Relating to the Election of Directors, Sec. Exch. Act Rel. No. 56161, 2007 WL 4442681 (July 27, 2007).

108. Shareholder Proposals, Sec. Exch. Act Rel. No. 56160, 2007 WL 2175940 (July 27, 2007).

any previous dealings with the company.[109] Unlike the 2003 proxy access rules, the 2007 proposal did not seek to dictate the terms of proxy access.

On November 28, 2007, the SEC, by a 3–1 vote, adopted the first proposal, overturning the AFSCME decision and prohibiting the use of Rule 14a–8 for proxy access proposals.[110] Chairman Cox explained the decision as preserving the status quo and preventing "an easy end run around the Commission's required disclosures and our antifraud rules in proxy contests."[111] He stated that the SEC would continue to study proxy access and revisit the issue.[112] There are reasons to question the Chairman's stated justification for the rule, especially because the proxy rules do not compel disclosure for issuers that voluntarily adopt proxy access bylaws. A variety of institutional investor groups, including the Council for Institutional Investors ("CII"), criticized the SEC's decision as obstructing the rights of shareholders.[113] Former SEC Commissioner Harvey Goldschmid termed the decision a "tragic mistake."[114]

At least two issuers have adopted shareholder access provisions voluntarily. In 2003, Apria Healthcare adopted a provision allowing shareholders owned at least 5% of the company to submit up to two nominees for inclusion in the company's proxy statement.[115] In 2007, Comverse Technology, adopted a proxy access bylaw, allowing shareholders who have owned at least 5% of the company for at least two years to submit one nominee for inclusion in the proxy statement.[116]

E. RECENT DEVELOPMENTS IN SHAREHOLDER VOTING RIGHTS

Although the SEC has not adopted a direct access rule, shareholder activism has affected the scope of shareholder voting rights. One significant development is majority voting. Historically directors in the United States are elected by a plurality vote. Contested elections are rare, in part because of the barriers to shareholder nomination of directors, as detailed above.[117] As a result, the vast majority of elections in publicly-

109. Id., 2007 WL 2175940.

110. Shareholder Proposals Relating to the Election of Directors, Sec. Exch. Act Rel. No. 56914, 2007 WL 4442610 (Dec. 7, 2007). See Greg Farrell, SEC limits investors' proxy power; Vote described as "tragic," "appalling" and "a sad day for shareowners", USA Today, Nov. 29, 2007, at 1B (describing the rule's adoption).

111. Chairman Christopher Cox, Speech by SEC Chairman: Electronic Shareholder Forum Rules; Codification of Interpretation of Rule 14(a)(8)(i)(8), SEC Open Meeting, Nov. 28, 2007, avail. at http://www.sec.gov/news/speech/2007/spch112807cc.htm.

112. Id.

113. Farrell, supra note 110.

114. Id.

115. Policy Regarding Alternative Director Nominations by Stockholders, Exhibit A to Apria Healthcare Group Inc., Def. 14A dated March 23, 2004, avail. at http://sec.edgar-online.com/2004/03/23/0000892569-04-000370/Section18.asp.

116. Ted Allen, Comverse Adopts Access Bylaw, ISS Corporate Governance Blog, Apr. 27, 2007, avail. at http://blog.issproxy.com/2007/04/comverse_adopts_access_bylawsu.html. The adoption of the bylaw appears to be part of an attempt by Comverse to address investor concerns following its involvement in stock-options backdating that led to the criminal prosecution of three company executives. Id.

117. Lucian Bebchuk reports that contested elections involving a rival team of directors seeking to run the company numbered approximately 12 per year between

traded companies involve a single slate of directors—those directors chosen by management or the company's board of directors In an uncontested election, shareholders lack the ability to vote "against" this incumbent slate; the shareholders' choice is limited to voting for the slate of directors or withholding voting authority.[118] Withhold votes have little legal significance and, as a practical matter, a director can be elected on the basis of as little as a single share voted in his or her favor.[119]

Despite the fact that withhold votes do not prevent a director from being elected, institutional investors in the 1980s began to "vote no" as a way of communicating their lack of satisfaction with an issuer. Institutions withheld votes from director candidates when they were dissatisfied with individual directors or to protest a board's lack of responsiveness to a particular shareholder concern such as a poison pill.[120] In some cases, activist institutions hired proxy solicitation firms to encourage shareholders to withhold their votes, creating a type of contested election despite the presence of a single slate of candidates.[121] Some commentators endorsed "vote no," arguing that it provided a valuable yet minimalist outlet for shareholder activism.[122] Withhold campaigns gradually increased in popularity, reaching a high point when 45% of shareholders withheld their votes from CEO and Chairman Michael Eisner at the 2004 Disney annual meeting.[123] During the 2004 proxy season, 12 directors received withhold votes of more than 50%.[124]

Despite the relatively low cost and accessibility of vote no campaigns, the Disney vote illustrated their limited effectiveness. In *Disney*, the board promptly voted a statement of confidence in Michael Eisner. The board eventually replaced Eisner as CEO, but it took a full year to

1996 and 2005. Of these, only 25%, or approximately 3 per year involved companies with a market capitalization exceeding $200 million at the time of the challenge. Lucian Bebchuk, The Myth of the Shareholder Franchise, 93 Va. L. Rev. 675, 686–87 (2007).

118. As Joseph Grundfest explains, "SEC regulations in effect since 1967 require that the 'form of proxy which provides for the election of directors ... provide ... means for security holders to withhold authority to vote for each nominee,' even when a board stands unopposed for reelection." Joseph A. Grundfest, Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates, 45 Stan. L. Rev. 857, 903 (1993).

119. The Delaware Chancery Court has determined that proxies that withhold authority on the issue of electing directors are present for purposes of the quorum requirement of the annual meeting. North Fork Bancorporation, Inc. v. Toal, 825 A.2d 860, 869 (Del. Ch. 2000). Moreover, withhold votes can be significant, as indicated below, if an issuer uses majority voting rather than plurality voting. See id.

120. See Joann S. Lublin, Lubrizol and TIAA–CREF Fund Duel Over "Dead-Hand" Takeover Defense, WALL ST.J., Mar. 23, 1999, at A4.

121. See, e.g., id. (describing TIAA–CREF's hiring of proxy solicitation firm in withhold campaign at Lubrizol 1999 annual meeting).

122. See Grundfest, supra note 118, at 857 (advocating "vote no" campaigns).

123. Ronald Grover & Tom Lowry, Now It's Time to Say Goodbye: How Disney's Board Can Move Beyond the Eisner Era, Business Week, March 15, 2004, at 30.

124. The ISS Institute for Corporate Governance, Majority Voting in Director Elections

From the Symbolic to the Democratic (2005), available at http://www.issproxy.com /pdf/MVwhitepaper.pdf.

do so.[125] Withhold votes might communicate shareholder dissatisfaction but, like precatory proposals, it appears that they do not reflect a meaningful exercise of shareholder power.

The next step was majority voting. As indicated above, the vast majority of U.S. corporations elect directors by plurality voting. Plurality voting is not the only option, however. In every state except Nevada (which requires plurality voting), corporations can utilize majority voting instead, and historically a handful of corporations have done so.[126] In January 2005, Business Week reporter Louis Lavelle published an article advocating majority voting.[127] The idea was promptly embraced by institutional investors and endorsed by the CII and the International Corporate Governance Network ("ICGN"), Others took majority voting seriously as well. The American Bar Association formed a task force on majority voting. Even the Business Roundtable conceded that majority voting "provides for enhanced accountability of board members to shareholders."[128]

By February 2007, a study revealed that 52% of Fortune 500 companies had adopted a policy, bylaw or charter provision providing for some type of majority voting.[129] Delaware amended its corporation statute to facilitate majority voting and to make it clear that director resignations in connection with majority voting policies were valid and binding. Legislation was introduced in California, that would have required majority voting.[130] California adopted the legislation in an amended form, similar to the Delaware statute, that facilitated rather than mandated majority voting.[131]

It is important to keep in mind that the effectiveness of majority voting depends critically on the issuer's holdover policy. The failure of a director to win a majority vote does not automatically lead to his or her removal. Rather, the director will typically remain as a holdover director until he or she resigns or is replaced. Many issuers have addressed the holdover problem by requiring a director who receives a withhold vote to

125. Id.

126. Id. (listing Fortune 500 companies with majority voting); see also North Fork Bancorp., 825 A.2d at 860, 864 (describing requirement that Dime directors be elected by an affirmative vote of a majority of shares present).

127. Louis Lavelle, "Commentary: A Simple Way to Make Boards Behave," BusinessWeek, Jan. 31, 2005.

128. Testimony of John J. Castellani, President, the Business Roundtable, before the House Committee on Financial Services, Mar. 8, 2007, avail. at http://www.house.gov/apps/list/hearing/financialsvcs_dem/htcastellani030807.pdf.

129. Claudia H. Allen, Study of Majority Voting in Director Elections, Feb. 5, 2007, at 1, available at http://www.ngelaw.com/files/upload/majority_callen_020707.pdf.

130. Senate Floor Analyses, Senate Bill 1207, May 16, 2006, available at http://info.sen.ca.gov/pub/05-06/bill/sen/sb_1201-1250/sb_1207_cfa_20060516_095323_sen_floor.html (describing bill).

131. See Senate Bill No. 1207, approved by the Governor on Sept. 30, 2006, avail. at http://www.corp.ca.gov/pol/leginfo/sb_1207.pdf (amending section 708 of the California corporation code to authorize California corporations to adopt majority voting); Cydney Posner, California Majority Vote Bill, In the News, Cooley, Godward, Kronish LLP, July 25, 2006, available at http://www.cooley.com/news/inthenews.aspx?id=39809420 (describing reformulation of the legislation from requiring to facilitating majority voting).

submit his or her resignation.[132] The resignation is reviewed by the board's Corporate Governance Committee, typically within a 90 day period, which then makes a recommendation to the board on whether to accept or reject the resignation.[133] Significantly, the board has the authority to determine whether or not the director will actually be required to resign. Additionally, should the board accept the director's resignation, it, rather than the shareholders, generally has the statutory authority to replace the removed director. Shareholders do not even have the right to approve the replacement director until the next annual meeting.

Because majority voting policies are quite new, their effectiveness has not yet been tested. Unless and until shareholders refuse to elect a director—a decision that is likely to occur much less frequently than the somewhat symbolic withhold votes—it remains unclear whether majority voting will increase board responsiveness or accountability.

Majority voting is the most recent development in the context of director elections, but shareholder voting is also receiving attention with respect to another critical corporate governance issue—executive compensation. As indicated above, executive compensation has been a controversial topic, and a subject of shareholder activism, since the time of the Transamerica case. John and Lewis Gilbert, for example, frequently sponsored shareholder proposals seeking to limit executive compensation, although the proposals never received majority approval.[134] Executive compensation has also been the focus of extensive SEC rule-making, as the SEC has continually expanded and refined the disclosure requirements applicable to an issuer's top executives.[135] Recent SRO rulemaking has sought to improve the process of setting executive pay by requiring the use of compensation committees composed of independent directors.[136] Investors, however, particularly institutions, have continued

132. The carefully crafted amendments to the Model Business Corporation Act, adopted by the ABA Committee on Corporate Laws in 2006, provide that a director who fails to receive a majority vote will continue to serve for no more than 90 days with no right to hold over. See The Committee on Corporate Laws, ABA Section of Business Law, Changes in the Model Business Corporation Act—Amendments to Chapter 7 and Related Provisions Relating to Shareholder Action Without a Meeting, Chapters 8 and 10 Relating to Shareholder Voting for the Election of Directors, and Chapter 13 Relating to Appraisal and Other Remedies for Fundamental Transactions, 61 Bus. Law. 1427 (Aug. 2006) (describing the amendments).

133. See, e.g., Pfizer Corporate Governance Principles, available at http://www.stoel.com/webfiles/CorpCounselRoundtable Pfizer-Nike-Intel-ProgressEnergy.pdf. (providing that a director who receives a majority withheld votes shall promptly tender his or her resignation, which will be considered by the Corporate Governance committee and then acted on by the board).

134. See, e.,g., Bainbridge, Talking Stockholder Part I, supra note 17 at 54 (describing Lewis Gilbert's proposals to limit executive compensation at American Tobacco); Emerson, supra note 33 at 540–41 (describing proposals submitted by the Gilberts dealing with executive compensation).

135. The SEC's initial requirements, which have subsequently been refined, are contained in Executive Compensation Disclosure, Sec. Exch. Act. Rel. No. 31327, 57 Fed. Reg. 48126 (Oct. 21, 1992). See generally Jennifer S. Martin, The House of Mouse and Beyond: Assessing the SEC's Efforts to Regulate Executive Compensation, 32 Del. J. Corp. L. 481 (2007) (describing SEC's regulatory efforts including revisions to its disclosure requirements).

136. See, e.g., New York Stock Exchange Listed Company Manual § 303A.05(a) (requiring listed companies to

to express concern both about overall levels of compensation and, more importantly, about the extent to which compensation is unrelated to performance.

Investors have sought to raise these concerns through the shareholder proposal process. As indicated above, shareholder proposals relating to executive compensation have had a mixed reception from the SEC staff, which has permitted issuers to exclude many such proposals as relating to the issuer's ordinary business operations. Since approximately 1992, however, the staff has generally permitted proposals concerning compensation of senior executives.[137]

The latest such proposals seek to have issuers adopt advisory votes on executive compensation, a so-called "say on pay."[138] The concept is modeled upon the process adopted by England in 2002, and subsequently adopted in several other countries, in which shareholders engage in a non-binding vote to ratify executive remuneration.[139] Say on pay proposals first appeared on proxies in 2006. In 2007, they have been introduced at dozens of companies and, at some, have received majority approval.[140] Legislation is currently under consideration in Congress that would mandate say on pay for U.S. issuers.[141] Recently Aflac became the first U.S. company to provide say on pay, announcing that it had voluntarily instituted a non-binding shareholder vote that would begin with its 2009 annual meeting.[142]

Extended scope of permissible shareholder proposals, increased shareholder access to the director nomination process, majority voting, and say on pay are all developments that are likely to increase shareholder voting power. As such, they represent a potentially critical change in the importance of the shareholder franchise. The shareholder franchise has also become more significant as certain shareholders have sought to harness shareholder voting power in order to effect more

have a compensation committee composed entirely of independent directors).

137. See Eastman Kodak Company (publicly available Feb. 13, 1992) ("[I]t is the Division's view that proposals relating to senior executive compensation no longer can be considered matters relating to a registrant's ordinary business."). See also Staff Legal Bulletin No. 14A (July 12, 2002) (modifying staff position on executive compensation proposals), available at http://www.sec.gov/interps/legal/cfslb14a.htm.

138. See, e.g., Affiliated Computer Services, Inc. No Action Letter, 2007 WL 945176 (March 27, 2007) (describing "say on pay" proposal submitted by AFSCME and rejecting effort by Affiliated Computer Services to exclude the proposal).

139. See Paul Hodgson, "Having a Say on Pay: A Brief History of Shareholder Voting on Executive Compensation" (Jan. 16, 2007) (available at www.thecorporate library.com (describing history of "say on pay")).

140. See L. Reed Walton, Motorola: Third Majority for "Say on Pay", ISS Corporate Governance Blog, May 31, 2007, available at http://blog.issproxy.com/2007/05/motorola_third_majority_for_sa_1.html (reporting majority approvals at Motorola, Verizon and Blockbuster).

141. See Marlene Kennedy, Getting a say on pay for execs, timesunion.com, Apr. 20, 2007, available at http://timesunion.com/AspStories/story.asp?storyID=582473 & category=BUSINESS & newsdate =4/20/2007 (describing progress of H.R. 1257, sponsored by Barney Frank, in Congress).

142. See Allan Sloan, Aflac Looks Smart on Pay, Wash. Post, May 29. 2007, at D1 (describing Aflac's voluntary adoption of "say on pay").

significant changes in corporate control and operations. Most prominent among such shareholders are hedge funds. Activist hedge funds, in particular, have begun to use short slate proxy contests in order to accomplish their objectives.

Hedge funds are lightly regulated investment funds that charge a performance fee and are sold to high net worth accredited investors. The term is used to distinguish hedge funds from regulated investment funds that are marked to retail investors, but the terminology also comes from the investment strategy of many hedge funds, which is designed to produce a return that is hedged against market risk. The hedge fund industry has grown tremendously in the last decade; currently an estimated 9000 hedge funds control assets of $1.4 trillion.[143] Hedge fund strategies vary enormously, but a number of hedge funds are activist investors, seeking to obtain board representation on their portfolio companies in hopes of encouraging structural or operation changes to improve performance.[144]

Unlike other institutions or retail investors, hedge funds hold large, concentrated stakes in their portfolio companies–the typical activist hedge fund may hold only 12–20 positions at any given time. This enables the hedge fund to overcome the collective action and free-rider problems associated with proxy contests.[145] As a result, proxy contests are on the rise.[146] Activist hedge funds have threatened proxy contests at dozens of companies in the past several years. Although many of the contests are settled before they go to a shareholder vote—often with management agreeing to nominate a couple of hedge fund representatives to the board[147]—Bill Bratton found 28 cases in which the contest went to a shareholder vote during the 2003–2006 time period. These cases represent real contests, with economic significance, in which shareholder voting matters. Hedge funds have been able to command the support of their fellow investors—winning proxy contests with surprising frequency. Of the contests that were resolved at the time of Bratton's study, hedge funds were successful 79% of the time. Significantly, Alon Brav, et al., report that hedge fund activism also has a positive impact on issuer performance and stock returns, and that this impact is not limited to the short window following the initial announcement of the fund's intended activism.[148]

143. Tomoeh Murakami Tse, Pension funds raise risk, dive into hedge funds, Wash. Post, July 25, 2007.

144. See William W. Bratton, Hedge Funds and Governance Targets, 95 Geo. L.J. 1375 (2007) (describing hedge fund activism and evaluating its impact on firm performance).

145. See, id. at 1381 (stating that "the activist funds have employed the proxy system, widely thought to be moribund, with remarkable, perhaps unprecedented, success.").

146. See Ellen Rosen, Hedge Funds' Activism Creates New Wealth for Law Firms, N.Y. Times, Apr. 20, 2007 (describing increase in proxy contests due to hedge fund activism).

147. Alon Brav and his co-authors describe an example in Pirate Capital's activism at James River Coal Co. See Alon Brav, et al., Hedge Fund Activism, Corporate Governance, and Firm Performance, working paper dated Aug. 30, 2007, at 13–14, avail. at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=948907.

148. Id.

F. THE MECHANICS OF THE VOTING PROCESS

As shareholder voting becomes potentially more significant, it is worth considering the mechanics of the voting process, which has received relatively little attention. Because most stock is held in street name, issuers do not mail proxy statements and other solicitation material directly to investors.[149] Instead, the majority of solicitation material is delivered to banks and brokers, who are then obligated by SEC rules to deliver the information to the ultimate beneficial owners of the stock. Banks and brokers outsource the mechanical process of delivering proxy materials to an intermediary—generally American Data Processing ("ADP").[150] The costs for ADP's services are borne by issuers. ADP also collects and tabulates shareholder voting instructions and provides a vote count to issuers. In recent years, ADP has developed mechanisms to enable shareholders to vote by mail, by telephone and over the internet.[151]

The process of collecting and tabulating votes has not kept pace with the market. One problem occurs when the beneficial owner fails to submit voting instructions. For many years, the NYSE handled this by allowing the brokers, who were, after all, the record holders, to vote stock for which no instructions had been received. This procedure is known as discretionary voting.[152]

NYSE Rule 452 provides that, if the beneficial owner of shares held in street name has not indicated how those shares should be voted, the broker may vote the shares in its discretion.[153] NASD Rule 2260(c)(2) piggybacks onto Rule 452 by providing that, if discretionary voting is permitted under Rule 452, the broker is also allowed to vote for Nasdaq listed companies.[154] Brokers have typically exercised that discretion to support management, including voting in favor of the company's recommended slate of directors. Thus discretionary voting historically provided incumbent management with a strong base of support. Broker voting offers a partial explanation of the low rates at which shareholder proposals are adopted. Discretionary voting is not permitted with respect to non-routine matters, such as mergers and election contests. The NYSE determines whether a matter is routine; it has set out in Rule 452

149. According to the SEC, "It has been estimated that as much as 85% of exchange-traded securities are held in street name." SEC, Roundtable on Proxy Voting Mechanics, May 23, 2007, available at http://ftp.sec.gov/spotlight/proxyprocess/proxyvotingbrief.htm.

150. ADP Investor Communications is now Broadridge Financial Solutions, Inc. See https://myservice.broadridge.com/public_site/default.asp (reporting name change). Since 1999 ADP, now Bridgeridge, has handled over 90% of all investor communications distributions in the United States to beneficial owners by banks and brokers. Broadridge Investor Relations, History, available at http://www.broadridge-ir.com/main/history.htm.

151. See Stephen Choi & Jill E. Fisch, How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries, 113 Yale L. J. 269, 301–04 (2003) (describing ADP's services).

152. See Roundtable on Proxy Voting Mechanics, supra note 149 (describing broker voting).

153. NYSE Rule 452, Giving Proxies by Member Organization.

154. NASD Rule 2260(c)(2).

a list of non-routine matters.[155] This determination has been criticized, particularly in light of the NYSE's decision that vote no campaigns in which there is no opposing director slate are routine matters.[156] Responding to these concerns as well as the challenged posed by majority voting, the NYSE recently submitted a proposed change to Rule 452 which, if approved by the SEC, would prevent brokers from engaging in discretionary voting in uncontested director elections.[157]

Another problem arises from the fact that ADP is responsible for deciding which votes to count. The process generally involves ADP cross-checking the number of votes received from beneficial owners against the broker's total holdings of record. So long as broker has not submitted votes for more shares than it holds, ADP will count the votes. In cases of an over-vote, ADP will generally go back to the broker for a reconciliation. Individual brokers use different processes to determine which votes to count, and that determination is not regulated.[158] The process of determining which votes are valid is not transparent either to issuers or shareholders. Moreover, the intermediation prevents shareholders from ascertaining that their votes have been properly received and counted.[159] It is worth noting that ADP is hired by brokerage firms, but its fees are borne by the issuer. This structure creates an agency problem in which ADP cannot easily be held accountable by issuers or shareholders.

A third problem with the vote-counting process can arise from short selling. When shares are shorted, they are borrowed from one owner, in order to be sold to a second owner. In theory, both owners have a claim to the voting rights associated with those shares.[160] Yet, if both owners vote, the shares will be voted twice.[161] ADP's procedures do not provide a mechanism to track potential over-voting, and such voting is only likely to trigger attention if it leads to the submission of more votes by a broker's customers than shares held. In rare cases, however, over-voting can skew the results of an election. As Ed Rock and Marcel Kahan explain, for example, the margin of victory in the controversial MONY/AXA deal was only 1.7 million shares out of 50.1 million, yet at the time

155. See Press Release, New York Stock Exch., NYSE Adopts Proxy Working Group Recommendation to Eliminate Broker Voting In 2008 (Oct. 24, 2006), available at http://www.nyse.com/press/1161166307645.html?sa campaign=/rss/newsreleases/NYSE.comRuleProposalsNewsReleases (describing NYSE process of classifying proposals as "routine" or "non-routine").

156. See Roundtable on Proxy Voting Mechanics, supra note 149 (identifying NYSE position that vote no campaigns are routine matters for purposes of NYSE Rule 452).

157. See Press Release, supra note 155.

158. Roundtable on Proxy Voting Mechanics, supra note 149.

159. See, e.g., Choi & Fisch, supra note 151 at 303 n. 159 (recounting examples of shareholder disputes with ADP's recording of their votes).

160. See Shaun Martin & Frank Partnoy, Encumbered Shares, 2005 U. Ill. L. Rev. 775, 779–80 (2005) (describing challenge of determining appropriate voting rights when stock is loaned).

161. See Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1079–82 (2007) (describing the over-voting problem).

of the vote, approximately 6.2 million shares had been shorted.[162] If voting rights were allocated improperly with respect to the shorted shares, an adjustment could easily have led to the opposite result.

The technical problem of determining how to count votes in the presence of short selling is the tip of a more significant problem—the question of whether a shareholder who limits his or her economic interest in a stock should retain the right to vote that stock. Shareholder voting rights are based on an ownership conception of the shareholder. Growth in derivatives and other financial innovations, as well as increased liquidity in the securities markets, have challenged this ownership conception. It is now possible to separate out legal title from economic interest by creating hedged positions in which a shareholder lacks an economic interest in stock but retains voting rights. Bernard Black and Henry Hu call this empty voting.[163] Derivatives also enable shareholders to acquire voting rights without acquiring the economic risk associated with ownership. Black and Hu term these rights "morphable voting rights."[164]

Whether shareholders should continue to retain voting rights if they partially or completely hedge their economic risk is an open question. Traditionally voting rights were based on legal title. At the same time, shareholders who lack an economic interest may exercise their voting rights in a way that is inconsistent with the interests of their fellow shareholders and the corporation. Some commentators have identified this as a particular concern with respect to hedge funds. Perhaps the most highly publicized example of this kind of behavior involves the proposed merger between Mylan Laboratories and King Pharmaceuticals.[165] The two companies entered into a merger agreement which was subject to shareholder approval. Based on market reaction, the merger was attractive for King, but not for Mylan. Perry, a hedge fund, owned approximately 7 million shares in King, and wanted the merger to be approved. Accordingly, prior to the vote on the merger, Perry purchased 9.9% of Mylan stock. Perry then entered into equity swaps that had the effect of fully hedging its position in Mylan. Accordingly, Perry obtained the power to vote 9.9% of Mylan stock with no economic interest in Mylan, freeing it to vote that stock in favor of the merger which would enhance the value of its King holdings. Although the merger fell through for other reasons, Perry's actions were widely criticized as empty voting or vote buying. Perry's actions were challenged in federal court by Carl Icahn,[166] but the failure of the merger mooted the question of whether Perry could be legally precluded from voting the Mylan stock before the court could consider it.[167]

162. Id. at 1081.

163. Henry T. C. Hu & Bernard Black, The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership, 79 Cal. L. Rev. 811 (2006).

164. Id.

165. See Rock & Kahan, supra note 161 (describing this transaction in detail).

166. See Jesse Eisinger, Long & Short: Icahn Cries Foul at Perry's No-Risk Play in Takeover Fight, Wall St. J., Dec. 15, 2004, at C1 (reporting on the litigation).

167. See Icahn Drops Mylan Labs Suit, Wall St. J., July 26, 2005, at C4 (reporting termination of litigation).

Interestingly, empty voting is not a recent innovation. In a 1911 New Jersey case, the management of a corporation reportedly borrowed stock and transferred it into the names of persons who were friendly to management.[168] After those persons gave management proxies to vote the stock, the company closed its books for the purposes of recording transfers. Thereafter, the loaned stock was returned to its true owners. Other stockholders challenged the right of management to use these proxies to vote the stock in their own interests rather than in the interests of the true owners. Although the court found that the challenged proxies were insufficient to affect the outcome of the election and therefore refused to grant any relief, the court observed in dicta that the proxy relationship was based on agency principles and that the true owner of the shares at the time of the meeting had the right to have those shares voted in his economic interest.

Whether state courts will respond to challenges such as empty voting remains unclear. On the one hand, state common law prohibits vote selling,[169] and state courts presumably have the power to invalidate votes cast by those who have purchased the right to vote divorced of any economic interest in the stock. On the other hand, the wide range of derivatives means that a substantial number of shareholders have hedged their economic interest in whole or in part. Courts currently lack easy mechanisms both for identifying the extent of such hedging and determining the circumstances under which it should deprive a stockholder of voting power. For example, a shareholder who owns both a share of stock and a put option entitling that shareholder to sell the stock on a future date at a preset price has reduced or eliminated his exposure to changes in market price. A shareholder who owns a share and simultaneously sells a share short has eliminated his economic interest in the stock but retains the right to vote the stock. Similar examples are relatively commonplace, and it is difficult to believe that all such shareholders can or should be disenfranchised.

G. THE LONG TERM IMPLICATIONS OF TRANSAMERICA

In the Transamerica case, the combined efforts of the SEC and the Third Circuit had the effect of largely federalizing the subject of shareholder voting. The SEC, through its adoption and implementation of the federal proxy rules, has been simultaneously both the dominant source of and the major constraint on shareholder voting power. Problematically, as the SEC's views on the appropriate allocation of authority between shareholders and corporate management have shifted, so have shareholder voting rights. Although the SEC has continually paid lip service to the proposition that its determinations are subject to the limits imposed by state law, both the no-action process and the decisions of the SEC and its staff when engaged in that process limit the opportunity for

168. Bache v. Central Leather Co., 78 N.J. Eq. 484 (1911).

169. See, e.g., Schreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982).

state law to develop to address the relevant issues. Concededly there are exceptional cases in which state courts have had the opportunity to determine the appropriate scope of shareholder voting power–the Fleming case is one example. But it is far more common for the SEC's decisions to preclude state court action. As a result, shareholders' substantive voting rights have been largely determined by federal law. SEC rules and no-action determinations have limited shareholder power to nominate directors and otherwise to control the election process. SEC rulings have forced many shareholder resolutions into the form of nonbinding precatory proposals instead of bylaw amendments, despite state corporation laws granting shareholders authority to amend the bylaws. And SEC interpretations have favored shareholder voting on social policy issues while limiting shareholder voice on poison pills, executive compensation and other governance issues.

Ironically, the strongest defense of this federalization of shareholder voting is also its biggest weakness. There is substantial evidence in the legislative history of the Securities Exchange Act of 1934 of management misuse of the proxy solicitation process to limit its accountability to shareholders.[170] Congress intended to address this problem by empowering the SEC to adopt rules that would protect the shareholder franchise. Both the SEC and the federal courts recognized and acted to further that congressional objective in the Transamerica decision–the SEC by acting to enforce John Gilbert's right to submit his proposals for a shareholder vote, and the court by refusing to allow Transamerica to circumvent the effect of the shareholder proposal rule through a bylaw provision.

Yet many critics claim that the SEC has largely abandoned its role as advocate of shareholder rights.[171] At times, the SEC appears to consider itself some type of corporate governance czar, charged with the task of evaluating the wisdom, in policy terms, of shareholder nominations, binding bylaw proposals, and say on pay. Problematically, the SEC's policy perspective has been strongly influenced by corporate management. As the history of the shareholder proposal rule demonstrates, the SEC has moved away from the position it espoused in Transamerica, increasingly toward restricting shareholder voting power. Both the SEC's imposition of ever-greater substantive limits on the scope of a permissible shareholder proposal and its increasing limitations in terms of shareholder qualifications, and number and length of proposals, reflect an agency perception that shareholder voting rights under rule 14a–8 are potentially abusive and must be narrowly constrained. It is difficult to find compelling evidence of such abuse in the history of proxy voting. Even the Gilberts, who pioneered the use of the shareholder proposal rule, and who were responsible for the majority of shareholder proposals in the years predating institutional activism, introduced proposals that, by modern standards, appear to be at the core of an

170. See Jill E. Fisch, From Legitimacy to Logic: Reconstructing Proxy Regulation, 46 Vand. L. Rev. 1129 (1993) (reviewing this evidence).

171. Farrell, supra note 110.

investor's legitimate interests–the appointment of auditors, reports of annual meetings, executive compensation and the like.

One solution would be for the SEC to get out of the business of refereeing shareholder voting. A shareholder proposal rule that provided shareholder access to the proxy, without subject matter limitations, subject to minimal procedural requirements, would return questions about the approximate scope of shareholder voting power to state courts.[172] A likely and beneficial result would be the development of a body of case law that addressed the extent to which the board's statutory authority to run the corporation constrains shareholder voting power. In addition, state courts would have the opportunity to address the ability of management to use procedural restrictions such as advance notice requirements to limit shareholder voting rights. In the end, the state legislatures and courts could make a determination about appropriate scope of management authority and the utility of shareholder voting in ensuring management accountability.

This solution might lead to a concern that, without SEC intervention, state courts and legislatures will restrict shareholder voting rights. The Delaware chancery court, for example, might have determined that Transamerica's bylaw operated as a valid limit on shareholders' statutory authority to amend the bylaws. An initial answer to this concern is that states already have the power to determine the scope of shareholder voting rights–the SEC rules do not permit shareholder proposals, nominations or proxy access beyond the rights granted by state law. If a state, such as Oklahoma, does not permit shareholders to amend the bylaws, a shareholder cannot introduce a bylaw amendment under rule 14a–8. A second answer is that state experimentation and variation with respect to shareholder voting is no different from the variation found in other areas of corporate law. Corporate scholars have largely defended regulatory competition and most believe that market forces will lead to the dominance of efficient legal rules.[173] In other words, under state regulation, the policy questions with which the SEC has struggled will be subject to the discipline of market forces. Should those market forces fail, as some believe they did in the1920s, Congress can intervene and subject the shareholder voting process to minimum federal standards.

172. The SEC could, of course, enforce a requirement that the shareholder proposal and supporting statement comply with rule 14a–9–full and accurate disclosure is at the core of the SEC's competence.

173. Representative scholarship arguing that state regulatory competition produces efficient corporate law includes Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977) and Roberta Romano, The Genius of American Corporate Law (1993). See also Jill E. Fisch, The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, 68 U. Cin. L. Rev. 1061 (2000)(evaluating regulatory competition and competing scholarly explanations for Delaware's dominance).