## Course:

*Corporations and Corporate Governance*

## Contents:

*Reading Materials, Session One:*

Economic Theory and Shareholder Voting

## Instructor:

Professor Robert J. Jackson, Jr.

## Meeting Details:

Monday, July 25, 9:45 AM to 11:45 AM

Jerome Greene Hall

## Readings:

During our first session together, we will consider why economic actors use corporations to pursue business affairs, how the separation of ownership and control of the corporation gives rise to agency costs and how shareholder voting to elect the corporation’s directors might influence those costs. In preparation for this session, please read the enclosed selected materials:

- **William T. Allen, Reinier Kraakman and Guhan Subramanian, Commentaries and Cases on the Law of Business Organization** (3d ed. 2009) (“AKS”) (please read only pages 1-5 (stop at Section 1.2), 8-13, 169-172, 175-76 (read only “Note on Staggered Boards”), 177-78 (read only Section 7.4), 202-204, 209 (stop at Section 7.9.1), 213-14 (stop at “Corporate Governance Proposals”).

- For necessary *statutory and regulatory background* on the AKS materials, please also read Securities and Exchange Commission Rule 14a-8 (in connection with AKS 213).

- Please also read the following *additional materials on recent developments* on shareholder voting in the United States: the *Business Roundtable v. SEC* case (pages 1-7 only; stop at “Consideration of Economic Consequences”), decided in July 2011, and the September 6, 2011 statement in response to the decision by Securities and Exchange Commission Chairman Mary Schapiro.

I very much look forward to discussing these materials with you at our first meeting on Monday morning!
COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION

THIRD EDITION

William T. Allen
Jack Nusbaum Professor of Law and Business
New York University
Of Counsel, Wachtell, Lipton, Rosen & Katz

Reinier Kraakman
Ezra Ripley Thayer Professor of Law
Harvard Law School

Guhan Subramanian
Joseph Flom Professor of Law and Business
Harvard Law School
H. Douglas Weaver Professor of Business Law
Harvard Business School
INTRODUCTION TO THE LAW OF ENTERPRISE ORGANIZATION

In large measure, civil law is concerned with facilitating voluntary economic relationships. Property law and contract law are the legal bedrock of market economies, but other bodies of law are also important. Among these are the laws of security interests, money and credit, bankruptcy, intellectual property, and enterprise organization. This book deals with the last, but hardly the least, of these fields: the law of enterprise organization. In particular, we address the laws of agency, partnership (and related entities), and corporations.

Because the problems that people encounter in their cooperative economic relations are recurring, the law creates a useful menu of standard forms to govern business relations. Thus, the laws of agency, partnership, and corporations can be seen as offering parties related sets of standard legal relations. Most of these relations are essentially contractual in the sense that they are voluntarily created and may be customized or fine-tuned by express agreement. As we shall see, however, the laws of agency, partnership, and corporations have a "property" dimension in addition to the contractual dimension, since they alter the legal rights of third parties as well as the rights of the parties who enter these enterprise relationships.

We begin our study with the law of agency. The agency relationship can be thought of as the simplest form of business organization. It may be terminated at any time by either the principal or the agent. In agency law, however, we see prefigured many of the most basic and difficult problems of corporation law, most particularly those arising from the so-called fiduciary duty of loyalty. From agency, we move to a somewhat more stable form of relationship, the general partnership—which we may think of as the simplest form of jointly owned business firm. Here we define "firm" loosely to mean a form of business relation that has a temporal dimension, a social identity, and a separate pool of dedicated business assets. Partnerships are usually simple joint enterprises of individual partners, subject to dissolution at the whim of any partner in the absence of a contrary agreement. By contrast, the corporate form—our principal subject—is the most stable, complex, and socially important form of business organization.
Before we address the law of business organization, we use this introductory chapter to discuss a few very general points. Throughout these materials, we not only describe the rules of enterprise law but also attempt to evaluate them. In doing so, we often use the concept of “efficiency” as a standard. Efficiency is a slippery concept, however, and discussing it is therefore our first priority.

After exploring the concept of efficiency, we address the relationship between efficiency and “fairness” in the law of business organization. Fairness is rarely a topic in academic discussion of corporation law because it is usually thought to be too vague to be analytically useful. Efficiency is the dominant, if not the sole, criterion for academic evaluation of corporate law doctrines. Yet courts, which in this area of law are powerful generators of legal norms, frequently invoke the concept of fairness in their opinions and rarely address efficiency, at least in so many words. This odd disjunction requires some explanation, which we offer in §1.2 below.

Lastly, we provide a brief outline of the modern learning on the economics of the firm in this introductory chapter. This is truly summary in nature, but even a brief review may prove helpful to the student or practitioner who is unfamiliar with the literature. We especially want to introduce early on the modern economics concepts of agency theory and agency cost, since they are significant theoretical perspectives on modern corporation law.

### 1.1 Efficiency and the Social Significance of Enterprise Organization

Wealth is an important ingredient of happiness for most of us. Money can’t buy everything, as the saying goes, but it can satisfy real human needs, reduce suffering, and help people achieve their full potential. Greater wealth is not always deployed to advance total human welfare, but it does create greater power to do so. In all events, the modern law of organizational forms—most notably corporation law—is premised on the idea that facilitating individuals’ efforts to create wealth is wise public policy.

As citizens, of course, we are concerned about far more than the creation of total wealth or even our share in it. We are concerned with the state of the world, the welfare of others, and the social policies that affect the distribution of wealth, although we might disagree about the particulars. But by and large, corporation law has been shaped within the classical liberal political paradigm as a field limited to only a slice of the human experience. Thus, legitimate political questions about, for example, the social distribution of wealth fall outside the competence of corporate law. The laws of taxation, education, environmental and labor policy, product safety, and other issues of health, safety, and welfare address the distribution of risks and rewards in society. Corporate law addresses the creation of economic wealth through the facilitation of voluntary, ongoing collective action.
1.1 Efficiency and the Social Significance of Enterprise Organization

1.1.1 Wealth Creation and the Corporate Form of Organization

Corporation law in particular deals with the creation and governance of the private legal entities that are the principal economic actors in the modern world. Thus, it deals with the control over vast aggregations of wealth and power. It addresses such important issues as how corporate enterprises are created and capitalized, how power over their internal affairs is distributed, how their economic performance is monitored, and what mechanisms exist to improve their performance.

Defined in this way, enterprise law is a practical subject. While there are no precise measures of the effect that organizational law has on economic productivity, we do have certain indicia of its significance. The bankruptcy of the old Soviet-style planned economy is exhibit one in an argument for the importance of incentives and the law of ownership, control structures, and legal protection of capital. Marxism doctrinally denied the productive contribution of capital to the collective effort to produce wealth. Anglo-American corporation law, on the other hand, recognized from the beginning the legitimate rights of the shareholders who contributed equity capital to business enterprise. The collapse of the Soviet economy and its political control system and the success of the Anglo-American model of legal regulation of large-scale enterprise suggest that an organization's internal governance affects its performance.

Additional evidence of the significance of the law of enterprise organization is the dominance of the corporate form throughout the world. The basic legal form of large-scale firms is remarkably similar in almost all economies. As we will see, their shared characteristics are the identifying characteristics of the corporate form. Naturally, there are differences, too, but they are concerned primarily with the sources of capital used to capitalize corporate enterprise in different countries. In some countries, like the United States and Great Britain, developed capital markets provide much of the equity (or risk) capital that flows to both new ventures and established ones. In others—such as Germany and Japan—financial intermediaries supply much of this capital. In these countries, banks, savings institutions, insurance companies, or other operating companies may be the dominant providers of capital. In still other jurisdictions, family groups may be the major source of equity capital. Thus, while the international differences are interesting, the similarities are more striking. The corporate form dominates in all instances where technology creates economies of scale.

1.1.2 What Do We Mean by Efficiency?

If we accept the classical liberal perspective that corporation law succeeds to the extent that it enables individuals to increase their utility, we implicitly agree that economic efficiency is the principal standard by which this law should be evaluated. Throughout this course, students will
be required to grapple with the question of whether a given rule of law (or a principle or practice) is likely to be efficient. Thus, at the very beginning, we should pause to consider what such a question means.

Our intuitive notion of efficiency is probably something largely unexamined but likely something in the manner of, say, the minimization of waste or the production of maximum output from given inputs. Economists have developed concepts that are more specific but still consistent with these intuitions.

1.1.2.1 Pareto Efficiency

The most basic definition of economic efficiency is that of the late-nineteenth-century Italian economist and sociologist Vilfredo Pareto. Pareto reasoned that a given distribution of resources is efficient when, and only when, resources are distributed in such a way (within a given group or territory) that no reallocation of resources can make at least one person better off without making at least one other person worse off. Economists describe such a distribution as "Pareto-optimal." This does not mean, however, that any ordinary person would describe the state as "optimal" or even tolerable. Like most post-Enlightenment thinkers, Pareto believed that utility is a subjective state of well-being that cannot be accurately assessed by outside observers. The only person capable of determining when a change of circumstances makes an individual better off or worse off is that individual herself. Thus, it is only through voluntary exchange, in which individuals reveal their own preference for one outcome over another, that we can be sure that any transfer or redistribution yields a utility gain for both sides of the transaction. And it is only when all parties affected by a transfer experience a net utility gain (or, at a minimum, one party experiences a gain and no party experiences a loss) that we can be certain that there is a net utility gain from the transaction overall. Such a transaction is said to be "Pareto-efficient."

But while Pareto efficiency is important, it has serious drawbacks as a tool for evaluating legal policies. To begin with, it is agnostic about the legitimacy of the original distribution of assets within a society. Pareto-efficient transfers are those that are certain to increase social welfare starting from a fixed starting point—an original distribution of resources. But in real-life policy formation by legislatures or courts (or in legal criticism by scholars or citizens), the legitimacy of the existing distribution is often contested.

Even more important, it is virtually impossible for courts or legislatures to make important decisions that do not make someone worse off. Indeed, even voluntary agreements among private parties sometimes fail the Pareto efficiency test because, although they make all of their signatories better off, they also impose uncompensated costs on third parties. Consequently, almost all public policies and many private arrangements fail the test of Pareto efficiency for the seemingly technical reason that, however much good they do on balance, they make at least one person worse off. Odd as it sounds, for example, even a law punishing fraud would
not be Pareto-efficient if it made the perpetrators of frauds worse off. It follows that Pareto efficiency is poorly suited to evaluating or criticizing the law of enterprise organization.

1.1.2.2 Kaldor-Hicks Efficiency

Another definition of efficiency that most people find more intuitive was developed by two English economists, Nicholas Kaldor and John R. Hicks. These authors sought to finesse the problem of externalities—that is, uncompensated costs imposed on parties without their consent. Under their definition, an act (or a rule) is efficient—that is, leads to an overall improvement in social welfare—if at least one party would gain from it after all those who suffered a loss as a result of the transaction or policy were fully compensated. Note that actual payment of any compensation is not stipulated in this definition. The idea here is that, because information is imperfect and transactions are costly, it is generally impossible to compensate all persons who are negatively affected by an action. Professors Kaldor and Hicks, consequently, simply replace the Paretian distributional constraint with the weaker rule that holds actions to be welfare-improving—or "efficient"—if they lead to a potential improvement in the Pareto efficiency sense because the gainers from these actions could, in theory, make the losers whole. In the happy case in which all the gains and losses can be evaluated in monetary terms, this is equivalent to saying that a transaction is efficient if the aggregate monetary gains to the winners exceed the aggregate monetary losses to the losers—that is, the total wealth of the affected parties increases. For this reason, the Kaldor-Hicks efficiency criterion is sometimes termed the rule of "wealth maximization."

To be sure, Kaldor-Hicks efficiency also has important limitations. Like the Paretian efficiency criterion, it has little to say about the legitimacy of initial distributions of wealth. Additionally, it can be criticized for ignoring the actual distributional consequences of policies and the difficulty of accurately measuring all of the negative (and positive) effects of third parties that follow a given action. Despite these limitations, however, Kaldor-Hicks efficiency has the decisive advantage of permitting lawyers and policy makers to compare the costs and benefits of a given action or legal change with the same metric. For this reason, it is vastly more workable than Pareto efficiency as a yardstick for policy makers. In particular, it has become a standard tool for evaluating enterprise law. Thus, when we speak of efficiency in these materials, we have Kaldor-Hicks efficiency in mind.

1.2 LAW FROM INSIDE AND OUT: SHARED MEANINGS AND SKEPTICISM

Another basic point we want to address before embarking on our review of the law concerns the analytical distinction between viewing law from the
access—but to the everyday notions of right conduct that courts assume most of the polity shares.

But if courts have an important role in creating the law of enterprise organization and yet do not actively employ the concept of efficiency in their work, how can we expect the legal system to even approximate a normative ideal of Kaldor-Hicks efficiency? A full answer must await our discussion of corporation law and especially the rights of shareholders. The short answer is that, when traditional corporation law addresses “fairness,” it generally refers to fairness to shareholders. Because shareholders are the residual claimants to the corporation’s income and assets, protection of their interests through a fairness norm is generally consistent with increasing total corporate wealth and with moving toward a Kaldor-Hicks efficient state.

1.3 Development of the Modern Theory of the Firm

Sophisticated business lawyers understand that they are in the business of structuring transactions to deal with forces that are largely economic or financial in nature. In business law, the lawyer who fails to understand the economics of a problem usually fails to find a satisfactory solution to the problem. Thus, in this section, we address the economic perspective on firms.

Curiously, economists were slow to ask why firms existed at all. In the eighteenth century, Adam Smith noted that firms facilitate specialization, allowing individuals to achieve greater productivity. But Smith also noted that joint stock companies offer an important disadvantage relative to sole proprietorships and small partnerships. They require hired managers, who, he posited, would work less diligently than would the owners themselves. Smith reasoned that owners of larger firms would have more difficulty in monitoring and controlling the behavior of managers and, therefore, that the corporate form (or the joint stock company, as it was then called) would remain little used. As we can see, this prediction was off the mark. Nevertheless, Smith’s focus on the problems that arise from agents managing a firm’s assets was prescient.

Economists were slow to take up Smith’s implicit invitation to study the incentive effects of owners and managers of firms. For most of the twentieth century, economics focused on what happened between competitive firms rather than on what happened within them. Put differently, economists studied markets. In doing so, they tended to assume the existence of a complete set of markets in which many informed buyers and sellers sought to maximize their utility. The prices in these markets contained all the information that any trader might need, and buying and selling generally tended to move prices toward an efficient equilibrium.

Real economic activity, however, only sometimes resembles tradings in these hypothetical markets. Most obviously, much economic activity is accomplished within firms and is thus not the product of market transactions at all. For example, shoemakers do not bargain with lace makers on the factory floor; a supervisor directs the flow of laces to shoes by fiat. In addition, much of what happens in markets is accomplished not by
individuals effecting simple buy/sell transactions but by firms entering into complex contracts. Oddly, or so it seems in retrospect, for a long time no one asked these questions: Why do these organizations exist? Are they efficient? And if they are, what is the source of that efficiency?

Economists were generally uninterested in a theory of firms. Scholarly investigation of large firms tended to focus instead on the way that they gained and exercised power over markets. Thus, studies of "market power," "concentration," "oligopolistic pricing," "monopoly power," "market definition," and other antitrust topics occupied the attention of many economists during much of the twentieth century. Until the 1970s, the internal organization and functioning of firms were largely ignored.

1.3.1 Ronald Coase's 1937 Insight

There is an important exception, however. In 1937, Ronald Coase published *The Nature of the Firm*. In this paper, Coase observed that the assumption of neoclassical economics that informed markets costlessly bring together buyers and sellers at an equilibrium price simply ignores many of the problems that real economic activity must solve. Coase hypothesized that, in reality, costs associated with transactions between market participants were substantial. He suggested that firms exist because, in a world of positive transaction costs, it is sometimes more efficient to organize complex tasks within a hierarchical organization— with its established authority and compensation structures— than on a market. Certainly, complex tasks could be accomplished on markets through a series of individualized buy/sell transactions. But where many steps were involved, Coase asserted, market forms of transacting would be costly, in part because they might require extensive negotiation or wasted effort to discover the best prices. Therefore, firms could be seen as innovations that permitted transactions, especially complex and reiterated transactions, to be accomplished more cheaply than they could be effected on markets.

This insight gave rise to a series of further questions; most notably: How can an entrepreneur or a scholar tell which activities will be more efficiently accomplished on markets and which within firms? What factors define the efficient boundaries of the firm? And how are people best motivated or controlled within firms?

1.3.2 Transactions Cost Theory

Remarkably, other economists did not take up these interesting questions until thirty years after Coase's original 1937 insight. Today, however, the "theory of the firm," as it is termed, is a burgeoning field within economics. While we cannot survey all of the important developments in

Chapter 1. Introduction to the Law of Enterprise Organization

this field, we should note two areas of ongoing research that are of particular significance in corporate law. The first of these areas—and the most direct application of Coase’s insight—is found in the pioneering work of Professor Oliver Williamson and others who seek, in a more detailed way than did Coase, to explain the firm as a set of transactions cost-reducing relationships (or “governance structures,” in Williamson’s terminology). In this view, owners of various resources are seen as committing to some “contractual” governance arrangement, such as the firm, in order to reduce their transactions costs and share the resulting efficiency gains.

1.3.3 Agency Cost Theory

Even more significant for students of corporation law, however, is the work of a second strain of modern economics that directly takes up implications of Adam Smith’s observations on the incentives of non-owner managers. This is the work of the agency theorists (or “principal-agent” theorists). Rather than focus on buyers and sellers who interact directly on markets, agency theory addresses how the actions of one actor (the “agent”) affect the interest of another (the “principal”), with whom she is tied by contract or otherwise. Agents in the economic sense typically act with respect to property that principals “own.” The pervasive reliance on these agents in our economy gives rise to a specific form of transactions costs.

Agency theorists share the assumption that economic actors are rational, informed, utility maximizers. Nevertheless, they are more realistic than earlier neoclassicist economists insofar as they view agents as maximizers of their own interests rather than the interests of their principals. Thus, according to agency theorists, a transaction may be motivated, in part at least, to serve an interest of a controlling agent rather than the interest of her principal. All legal forms of business firms, including the corporate form, can be viewed through this principal-agent lens.

Building on the work of Professors Armen Alchian and Harold Demsetz, a 1976 article by Professors Michael Jensen and William Meckling provided a clear statement of the nature of the firm under this perspective. Jensen and Meckling assert that the firm could best be understood as a complex of “contracts” between owners of the various factors of production of the firm. In this view, management is seen as offering to investors a share of the utility that can arise from centralizing information and expertise in a single enterprise.

The basic insight of the agency approach is that, to the extent the incentives of the agent (i.e., the person or interest that possesses discretionary power over some aspect of the principal’s investment in the rela-

1.3 Development of the Modern Theory of the Firm

tionship) differ from the incentives of the principal herself, a potential cost will arise that is termed an "agency cost." Thus, an agency cost is any cost—explicit or implicit—associated with the exercise of discretion over the principal's property by an agent. In the case of corporate managers, agency costs include obvious costs such as salaries or benefits. But they also include costs that are not so evident. For example, since managers are not owners, they cannot expect to receive all of the gains from investment decisions they make on behalf of the corporation, but they certainly bear some of the costs if they make poor investment choices. If, for example, the firm goes broke as a result, they will lose their jobs. Therefore, the risks and rewards of managers may be out of alignment with the interests of shareholders. At the margin, managers will inevitably fail to optimize firm value. Consider the following example.

PROBLEM

Proprietor Jonas, a rational utility maximizer, owns a thriving business that requires him and some of his employees to stay in New York for days at a time. Last year Jonas stayed in New York City for 46 nights, for a total hotel cost of $16,100; others stayed for a total of 16 nights, for a total of $3,200. Jonas sometimes has difficulty getting into the hotel of his choice and, all things considered, would prefer to stay in a comfortable apartment on Fifth Avenue, which his company could acquire at a net cost of about $70,000 a year. What will Jonas choose to do? Now, assume that Jonas sells 90 percent of the stock in the company in an initial public offering but continues to be CEO. Will he still make the same decision?

Professors Jensen and Meckling suggest three general sources of agency costs: monitoring costs, or costs that owners expend to ensure agent loyalty; bonding costs, or costs that agents expend to ensure owners of their reliability; and residual costs, or costs that arise from differences of interest that remain after monitoring and bonding costs are incurred. Jensen and Meckling's model assumes that the principal bears all of these costs. In the case of corporations, for example, the principal is the entrepreneur who originally sells shares at a price that reflects the market's expectations about the degree of opportunism that managers and controlling shareholders are likely to engage in. (This claim assumes an efficient primary market in shares, of course.)

Agency theory can also be employed to understand aspects of relationships beyond those of the owners or investors and the managers. From the perspective of agency theory, the corporation (and, indeed, all jointly owned business organizations) gives rise to agency problems. The first is the conflict between managers and investor/owners, which we addressed in the discussion above. The second agency problem arises from the ability of majority owners to control returns in a way that discriminates against minority owners. The third agency problem is that which exists between the firm and all other parties with whom it transacts, such as creditors of the firm. In fact, all parties who transact with the firm, and not just investors,
Consider these two excerpts, published days apart in *The Wall Street Journal*. What would Jensen & Meckling's agency theory say about this behavior? What alternative explanations might there be?

**Executives on Trial: Newest 'Tyco Gone Wild' Video is Out**


Yesterday, jurors in the corporate-rioting trial of former Tyco International Ltd. Chief Executive L. Dennis Kozlowski were shown a 15-minute video of Mr. Kozlowski's opulent, $18 million apartment on Fifth Avenue in Manhattan. Prosecutors contend most of the duplex apartment's furnishings, including a $15,000 umbrella stand, were improperly bought with Tyco assets. But it was the famous [$6,000] shower curtain that everyone was waiting to see. When news of the costly fabric first surfaced last year, it became a symbol of corporate excess, the butt of jokes by late-night TV comedians. The tape also featured stills shots of artwork, such as paintings by French Impressionists Claude Monet and Pierre Auguste Renoir, that prosecutors say Mr. Kozlowski bought with Tyco money, without authorization from the company's board.

**Getting Lord Black Off Hollinger's Tab**


Lord Black, an imperious newspaper proprietor who climbed as high as the U.K.'s House of Lords, resigned as Hollinger International's chief executive last week after a board committee disclosed that he and other top officials received unauthorized payments totaling $32.2 million. ... Hollinger has also grounded its air fleet. The plane used mostly by Lord Black—a leased Gulfstream IV—was recently refurbished at a cost of $3 million, according to company filings with the SEC. Improvements included a handcrafted table made of an exotic wood and a luxury sofa with a fold-out bed, according to one person who toured the plane. Meals prepared in the plane's galley are served with Christofle silverware. Mr. Badenhausen [a spokesman for Lord Black] says the renovation is "standard for corporate aircraft." According to a company official, Hollinger also is considering selling the papers that belonged to President Roosevelt, the subject of a recent book by Lord Black. The company hasn't publicly explained the reasons for the $8 million purchase. Asked by the Financial Times this summer why he didn't buy the papers himself, Lord Black responded: "$8 million was not something I was prepared to spend."

are likely to confront imperfections in contracting that expose them to the prospect of a firm's behaving opportunistically toward them. Unless the law or the parties craft protections from these risks, contracting parties (suppliers of equity capital, credit, labor, or other inputs) will demand higher returns to contract with the firm. (With respect to the agency problem faced by creditors, see Chapter 6.)

Using the metric of total assets, the corporation is the most important legal form of business organization. As we describe in Chapter 4, this form succeeds because it reduces the transactions costs of complex economic contracting. But the corporate form does so at the risk of creating agency
1.3 Development of the Modern Theory of the Firm

problems that must be constrained if it is to succeed. Thus, a principal aim of corporation law is the reduction of agency costs of all sorts.

Before turning to the corporate form, however, it is useful to consider the role of the law in reducing transactions costs in two simpler contexts. Hence, Chapter 2 is dedicated to the law of agency, from which the economic concept of agency cost derives its name. (Note that the legal concept of agent is related to the economic concept but is narrower in scope.) Chapter 3 introduces the partnership form, which, apart from natural persons, is the simplest form of legal entity for conducting business and may be understood as a precursor and alternative to the corporate form.
NORMAL GOVERNANCE: THE VOTING SYSTEM

7.1 THE ROLE AND LIMITS OF SHAREHOLDER VOTING

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

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

In this chapter, we address the shareholders’ most basic voting right: the right to elect the board of directors. We also touch on many associated topics, including calling annual meetings, affording information to shareholders, voting by proxy, and removing directors from office. In aggregate, these topics cover the “normal governance” machinery of the corporation. We reserve for later chapters detailed consideration of the law bearing on

1. We are grateful to Dorian Barag and Tibor Nagy for their extensive editorial suggestions and proposed problems for this chapter.
proxy contests and on shareholder rights to vote on fundamental transactions: for example, an amendment of the charter, a merger, a sale of all assets, or a dissolution. These topics are addressed in Chapters 12 and 13.

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

In the second extreme case, assume that shares in the corporation are held by 100,000 shareholders, each with a $100 investment. In this case, informed shareholder action (vote) would require that some investment in information be made by a very large number of shareholders. This would be collectively and individually costly. Any one shareholder's prospective share of the potential benefit that informed action might produce would probably not justify her personal costs. But more important, any one shareholder's vote is quite unlikely to affect the outcome of the vote. Thus, a shareholder is likely to get the same proportionate share of any benefit, without regard to whether she invests in becoming informed and voting intelligently. Economically, her incentive is to remain passive. Conversely, the larger a shareholder's proportionate stake is, the greater the probability that her vote will affect the outcome and the less she suffers from this problem of "rational apathy." But for our stylized firm of 100,000 equal shareholders, the shareholder collective action problem would preclude informed shareholder action; rational shareholders would be highly unlikely to challenge board decisions or even inform themselves about the company's performance beyond following the price of its stock. Thus, in this polar case, too, the voting system might largely be seen as a formality.

In the past, commentators tended to treat most American corporations as representative of one or the other of these extremes. Indeed, since Professors Adolf Berle and Gardner Means first confirmed the rise of a seemingly autonomous managerial class in the 1930s, the second case (that of the diffusely held company with a passive shareholder base) has been the conventional model of the large American public corporation. Commentators have not always thought this arrangement of passive shareholding was optimal, however, and attempts have been made to create a more active "shareholder democracy." Most notably, the 1934 Securities and Exchange Act sought to empower shareholders through forced disclosure of information (see the discussion of §14 of the 1934 Act below), and the courts have tended to aid this process by implying private remedies under that Act. The Securities and Exchange Commission (SEC), acting under the color of §14, has promulgated elaborate proxy rules designed

2. See, e.g., DGCL §242 (charter amendment), §251 (merger), §271 (sale of substantially all assets), and §275 (dissolution).
7.1 The Role and Limits of Shareholder Voting

to encourage informed shareholder voting. Ironically, until their amendment in 1992, these rules, by increasing the expense associated with shareholder communication, may have encouraged even greater voting passivity among shareholders.4

But not everyone agrees that mandated disclosure makes shareholders effective monitors. Some economically oriented commentators believe that the collective action problem is fatal in diffuse public capital markets no matter how much information is available. These commentators argue that managers are constrained not by shareholder votes but by the pressures exerted by multiple markets: the product market, the market for managerial services (including compensation incentives), the capital market (which must be accessed for funds), and most dramatically, the market for corporate control.5

Notwithstanding widespread academic pessimism about the inevitability of shareholder passivity, however, a new shareholders' rights movement led by institutional investors holding large blocks of shares emerged at the end of the 1980s. The new movement has had some notable successes. In the 1960s and 1970s, no one would have expected the governance upheavals of the 1990s, where, under pressure from institutional shareholders, boards of directors of such leading firms as General Motors, IBM, Sears, Westinghouse, and American Express fired their CEOs for poor performance. Institutional shareholder activism received a boost in 1992, when the SEC amended the proxy rules to allow large shareholders to communicate more easily with respect to a forthcoming corporate vote, without incurring the expense of filing proxy solicitation materials with the SEC.

The rise of the shareholder rights movement has sparked a literature of explanation, celebration, and criticism. The most important observation of this literature is that we no longer live in a world of extreme cases in which collective action costs are either nonexistent (because the corporation has a controlling shareholder) or preclusive (because stockholding is highly diffuse). Instead, growing institutional portfolios, cheaper costs of communication between institutions, and the evolution of new agents of shareholder organization (such as Institutional Shareholder Services6) have created ownership and coordination structures that fall between these two extremes. In today's modal public corporation, collective action costs may be large but perhaps not large enough to prevent shareholders from monitoring managerial performance. Thus, the regulation of shareholder voting and proxy solicitation really does matter for the typical public corporation today.

6. Institutional Shareholder Services (ISS) has become a powerful for-profit organization that provides proxy voting advice to institutional shareholders and corporate governance advice to major companies, among other services. On hotly contested issues (e.g., takeover contests, or, more recently, majority voting proposals) ISS's recommendation can determine the outcome. For more information on ISS, see their Web site, www.issproxy.com.
7.2 Electing and Removing Directors

7.2.1 Electing Directors

This is the foundational—and mandatory—voting right. Every corporation must have a board of directors, even if the “board” has only a single member. DGCL §141(a). And every corporation must have at least one class of voting stock. Indeed, in the absence of any customization in the charter, each share of stock has one vote—no more, no less. DGCL §212(a). However, the legal mandate that there be some voting stock is in fact a trivial constraint on governance design. It is possible to create nonvoting common stock and a single class of voting stock containing a single share. Of course, such one-class, one-share voting stock is never encountered in practice. Rather, in publicly financed corporations, most equity takes the form of voting common stock.

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

Another mandatory feature of the voting system is the annual election of directors. Each year, holders of voting stock elect either the whole board, when there is a single class of directors, or some fraction of the board. For example, shareholders elect one-third of the board annually when the charter provides for a “staggered” or “classified” board made up of three “classes” of directors, each serving three-year terms. See DGCL §141(d).

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

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

... them happen to believe that Revesz is the best leader a fashion e-company could have, even if the stock price is now quite low.

Six months later a well-known takeover artist, Qwen Vicious Kagan, purchases 51 percent of the outstanding Village, Inc. stock from numerous holders and consults you to devise some method of immediately assuming and exercising actual control over company policy. Kagan has been told that she is powerless for three full years. What advice would you give her (a) under Delaware law; (b) under the (old) Illinois Act, assuming provisions similar to Delaware with one exception, which reads as follows:

The power to make, alter, amend, or repeal the bylaws of the corporation shall be vested in the board of directors, unless reserved to the shareholders by the articles of incorporation.

Consider in this connection Ms. Kagan's ability to use the following possible actions to advance her plan: (1) amending the certificate of incorporation, (2) amending the bylaws; (3) increasing the size of the board, (4) removing one or more directors, and (5) dissolving the company and distributing its assets.

Are there other facts that you must know before giving your opinion? Suppose that, instead of amending the bylaws, Revesz had managed to insert all of the above changes in the certificate of incorporation. How could he?

NOTE ON STAGGERED BOARDS

As the preceding problem illustrates, a staggered board makes it more difficult for a shareholder—even a shareholder who holds 51 percent of the stock—to gain control of the board of directors. Under a "unitary" board, in which all directors are elected annually, a shareholder has a clean shot at electing a full board once a year. But when the board is staggered, a shareholder must win two elections, which can be as long as thirteen to fifteen months apart, in order to gain majority control (specifically, two-thirds of the seats) on the board.

It is important to note that a shareholder may have ways to "disassemble" a staggered board to avoid the two-election problem. For example, a shareholder might be able to "pack" the board with new directors, or remove directors without cause and replace them with new directors. But if a staggered board is "effective" (nongevadable), then a shareholder who wants control of the board must wait at least one year and perhaps as long as two years, depending on when the challenge is launched relative to the annual meeting date.

This difference between unitary and staggered boards becomes most relevant in the context of a hostile takeover bid. As we shall see in Chapter 13, the invention of the "poison pill" in the mid-1980s made control of the board a prerequisite for acquiring a company's shares. A staggered board makes board control more difficult. Sure enough, empirical work shows that targets of hostile takeover bids are significantly more likely to remain...
independent when they have a staggered board than when they have a unitary board.\textsuperscript{10} The data further shows that targets that remain independent do not, on average, achieve the same returns for their shareholders as they would have received by accepting the hostile takeover bid.\textsuperscript{11} Putting these facts together suggests that staggered boards, on average, "entrench" boards and managers in ways that deter value-increasing hostile takeover bids. Consistent with this conclusion, a subsequent empirical study finds that companies with staggered boards had lower total shareholder returns than companies with unitary boards during the 1990s.\textsuperscript{12} What countervailing benefits might staggered boards provide that are not captured by the empirical studies?

7.3 \textbf{SHAREHOLDER MEETINGS AND ALTERNATIVES}

In addition to the election of the board at the annual meeting, shareholders may consider other business. Thus, shareholders may also vote to adopt, amend, and repeal bylaws; to remove directors; and to adopt shareholder resolutions that may ratify board actions or request the board to take certain actions. Should the board fail to convene an annual meeting within thirteen months of the last meeting, courts will entertain a shareholder's petition and promptly require that a meeting be held in a summary action. See, e.g., DGCL §211.

\textbf{Special Meetings.} Special meetings of shareholders are those other than the annual meeting called for special purposes. Often they are called to permit shareholders to vote on fundamental transactions. Additionally, in most jurisdictions, a special meeting is the only way that shareholders can initiate action (such as, the amendment of bylaws or the removal from office of directors) between annual meetings. Therefore, who may call a special meeting and how a special meeting is called are matters of considerable importance.

If you were designing an ideal corporate governance structure, when would you permit shareholders to call a special meeting over the objection of the board? Presumably, the more that investors monitor corporate management, \textit{ceteris paribus}, the lower wasteful agency costs will be, and to that extent, the lower the firm's cost of capital will be. This factor weighs in favor of permitting shareholders to call special meetings easily, where, for example, they might act to remove directors. Yet shareholder meetings are costly, especially for public companies. Their costs involve not only financial expenditures, but also the lost time of senior executives.


\textsuperscript{11} See Bebchuk, Coates & Subramanian, \textit{Further Findings}, supra note 10.

Thus, like many issues of corporate law, we can easily state the general principle (maximize the value of the firm), but we cannot apply it without controversy to the choice of a rule. Either encouraging special meetings (and accepting the costs) or discouraging them (and allowing bad directors to stay in office) may increase or decrease the value of the firm.

Putting the matter of meetings in the corporate charter allows corporate planners to decide for themselves in particular cases. The Revised Model Business Corporation Act (RMBCA) offers a typical solution. Under §7.02, a corporation must hold a special meeting of stockholders if (i) such a meeting is called by the board of directors or a person authorized in the charter or bylaws to do so, or (ii) the holders of at least 10 percent of all votes entitled to be cast demand such a meeting in writing. Delaware law provides that special meetings may be called by the board or by such persons as are designated in the charter or bylaws. It does not contain the mandatory 10 percent provision that is found in many state (and foreign) statutes. See DGCL §211(d). Thus, absent a provision in the charter or bylaws, even a 10 percent shareholder cannot call a special meeting on her own authority in Delaware.

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

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

### 7.4 Proxy Voting and Its Costs

Shareholder meetings require a quorum to act. Given the widely dispersed share ownership of most publicly financed corporations, public shareholders are unlikely to actually attend shareholder meetings. As a result, in order to gather a quorum, the board and its officers are permitted to collect voting authority from shareholders in the form of proxies. In doing so, management acts on behalf of and at the expense of the corporation. In short, proxy voting is fundamental to corporate governance in publicly financed corporations. State corporation law establishes its validity as well as the legal structure in which proxies are given, exercised, and revoked. See, e.g., DGCL §212(b); NYBCL §609.
There is no single form that is mandated for a valid proxy. Generally, proxies must record the designation of the proxy holder by the shareholder and authenticate the grant of the proxy. In traditional terms, this was, and most often still is, a signed "proxy card." Modern statutes do recognize that electronic communications may also be used to designate a proxy, so long as sufficient evidence of authenticity is supplied. See DGCL §212(c)(2). A proxy holder is bound to exercise the proxy as directed. This requires a list of the specific nominees and specific issues on which the proxy holder proposes to vote. In most cases, however, proxy holders may exercise independent judgment on issues arising at the shareholder meeting for which they have not received specific instruction. Proxies, like all agency relationships, are revocable unless the holder has contracted for the proxy as a means to protect a legal interest or property, such as an interest in the shares themselves. See DGCL §212(e); Haft v. Haft, 671 A.2d 413 (Del. Ch. 1995) (proxy held by CEO was irrevocable because of proxy holder's interest as officer of the corporation).

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

On one hand, the costs of soliciting proxies are a matter of normal governance because subsidizing these costs from the corporate treasury is essential for the operation of annual shareholder meetings. In the normal governance setting, management must be allowed to expend corporate funds to call annual meetings and solicit proxies (otherwise shareholder rational passivity would make annual meetings impossible). On the other hand, authorizing the board to expend corporate funds on its own re-election seems to permit a kind of self-dealing. Specifically, in proxy fights for corporate control (see Chapter 13) it gives the board a financial advantage over others. This raises the question whether the law ought to encourage insurgent shareholders to solicit proxies by reimbursing their reasonable expenses as well. Under current law, such expenses are not reimbursed unless the insurgents are victorious in their proxy fight, in which case they can vote to reimburse themselves. What are the risks of such a reform and what benefits might we hope for?

In July 2007, the SEC promulgated its long-awaited "eProxy Rules," which have the potential to significantly reduce the cost of soliciting proxies for companies and insurgents. Under the new Rule 14a-16, available in your statutory supplement, all public companies must post their proxy materials on a publicly available website, and may simply mail a "Notice of Internet Availability of proxy materials" to shareholders no later than forty calendar days before the shareholder meeting. Importantly, third parties can also take advantage of the new "notice and access" model for distributing proxy materials. The new rules went into effect for all public companies as of January 2009, so the long term implications for proxy solicitation costs (and therefore proxy contests) are still unknown. For now, the question of reimbursement for proxy expenses remains an important one.
a company group less transparent, which is said to be a reason for their popularity in Asia.¹⁹

Neither pyramids nor cross-ownership are popular in the U.S. or the U.K. One reason for their paucity in the U.S. is that we impose an income tax on inter-corporate dividends. Thus, there is a significant tax penalty on moving corporate distributions through two or more levels of corporate structure. A second reason is the Investment Company Act of 1940, which imposes stringent regulatory and reporting requirements on group structures tied together by webs of minority holdings. It follows that the only ownership structure suitable for separating cash flow from ownership in the U.S is dual class common stock.

American corporate law does not require all shares to have voting rights, nor does it require all voting shares to have equal voting rights.¹⁹ Thus, most U.S. jurisdictions permit super-voting stock. Some economically oriented scholars believe that a dual-class voting stock may be the most effective (and most obvious) device for separating voting rights from cash flow rights and entrenching an individual or group as a controlling minority shareholder. The controversial character of dual-class stock in the United States raises several interesting questions. For example, how many of these firms are there really? Why were they created? Finally, are these structures really as inefficient as theory suggests they are likely to be?

Some answers are clear, some are not. To begin, dual-class share structures are rare among public companies (closely held companies are another matter). Some commentators suggest a historical explanation for this. For many years, the New York Stock Exchange (NYSE) would not list common stock that did not possess equal rights.²⁰ Since access to the NYSE was essential for public companies, firms simply did not adopt dual-class structures. (But would they have acted differently without the dual-class Exchange rule?)

Some economically oriented scholars believe that a prohibition on dual-class structures is unnecessary, given how a corporation's capital structure is formed. At the IPO stage, when the firm has few or no agency problems, corporate planners have an incentive to construct the best capital structure (i.e., the one the market will value most highly). Arguably, there may be some corporations in which a disjunction between control rights and rights to return is desirable. The case of newspapers is occasionally cited. These firms often have family control (a family controls The New York Times in a dual-class corporation), and that control is thought by some to add value by credibly committing the firm to a particular editorial

¹⁹. See, e.g., DGCL §151(a); NYBCA §613. Note that some non-U.S. jurisdictions, such as Germany, have adopted a mandatory one-share, one-vote rule.
approach. In all events, whether or not dual-class voting structures are efficient, economists conventionally assume that IPO pricing is efficient. Thus, if IPO entrepreneurs sell low-vote stock, public investors who discount accordingly will always get what they pay for.

Dual-class structures are more problematic, however, when they are adopted in "midstream," after the firm is already publicly trading. They can be adopted midstream only by a charter amendment requiring a shareholder vote. But such a vote might not protect public shareholders who face a collective action problem.\(^{21}\) Those proposing a dual-class voting structure can exploit the collective action problem by offering public shareholders a minor benefit in consideration for accepting diluted voting power. For example, the corporation might exchange one share of the old common stock for one share of new Class A common stock or one share of new Class B common stock. The Class A will have all of the rights of the old common stock plus its holders will receive a one-time special dividend (say, 50 cents a share). The new Class B stock will have those same rights except (1) it has no right to a special dividend, (2) it has ten votes per share, and (3) whenever it is transferred (except by death or inter vivos gift to a family member), it will automatically be converted into the same number of Class A common shares.\(^{22}\) The result, of course, is that management soon accumulates control over the company. Might such a transaction be efficient?

---

GOOGLE BALONEY


[In addition to the Dutch auction process for allocating IPO shares,] what else set tongues a-flapping was Google's decision to issue two classes of stock, giving its founders, Larry Page and Sergey Brin, as well as CEO Eric Schmidt, super-voting shares worth 10 times the voting weight of an ordinary share. As the prospectus frankly states, the goal is to entrench insiders in control of the company.

The Googlers don't mention the $800 heated toilet seats. Investors will have to judge whether such bennies are genuine productivity builders—or whether they count as "on-the-job consumption," one of the "private benefits of control" that academic economists traditionally regard as the motive for voting-power lockups. To translate, that's a nice way of saying insiders are living it up at shareholder's expense.

Dual-share companies have become more common lately as founders seek to entrench themselves after going public.


22. See, e.g., Lecos Land Company v. Arden Group, Inc., 517 A.2d 271 (Del. Ch. 1986) (injunction against shareholder vote on management's effort to amend charter in a similar way; basis was that management wrongfully coerced the vote by threatened breach of duty if approval was not forthcoming). Compare Blasius Corp v. Atlas, in Chapter 15.
Perhaps so, although one suspects that most managers who propose midstream charter amendments hope to extract value from shareholders.

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

**QUESTION**

While agency theory seems to imply that control and cash flow rights should be aligned, can you think of reasons why it may be efficient for some firms to adopt dual-voting structure as Google has done? Note that among the firms with this structure is Berkshire Hathaway, which is controlled by famed investor Warren Buffett. Might the market believe that the particular controllers of these two firms are uniquely capable of creating value? In many entrepreneurial firms that go public with a dual-class voting structure, the charter mandates that high-vote shares will convert to one-share/one-vote stock if the “original holder” (the entrepreneur) transfers them to a third party. This was the case, for example, in the Omnicare case discussed in Chapter 13.

### 7.8 The Collective Action Problem

The fact that public shareholders often approved devices that entrenched minority shareholders in the 1980s, such as dual-class recapitalizations, points to the public shareholders’ collective action problem. Even a one-share, one-vote rule cannot protect shareholders who habitually approve management proposals. Early academic commentators stressed the severity of the collection problem, and consequently saw shareholder voting as a mere adjunct to the takeover marketplace. Subsequent commentators found potential solutions with institutional investors, if legal restrictions were loosened, while others were skeptical that institutions could ever play an active role in corporate governance. The latest commentators point to hedge funds as the solution to the collective action problem. The following excerpts follow the evolution of the thinking on this core problem in corporate law.
7.9 The Federal Proxy Rules

7.9 THE FEDERAL PROXY RULES

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

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

The federal proxy rules consist of four major elements:

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

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

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

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

23. There are a few exceptions to this generalization. See, e.g., Mich. Bus. Corp. Act §901, which requires corporations to distribute financial statements to shareholders.
7.9 The Federal Proxy Rules

7.9.2 Rule 14a-8: Shareholder Proposals

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

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

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

Most Rule 14a-8 shareholder proposals fall into one of two categories: corporate governance or corporate social responsibility (CSR). Before 1985, 14a-8 proposals were mostly about CSR, which embraced topics ranging from environmental policies to personnel practices. Many such CSR proposals are still brought each year, although they rarely win more than 10 percent of the shareholder vote. More common today are proposals dealing with corporate governance matters. Professors Randall Thomas and James Cotter found that 72 percent of 14a-8 proposals submitted between 2002 and 2004 dealt with corporate governance issues.27 These proposals addressed issues ranging from executive compensation (27 percent of the Thomas and Cotter sample) to "internal" corporate governance proposals such as the separation of the chairman and CEO roles (19 percent of the sample) to "external" corporate governance proposals such as dismantling poison pill or staggered board takeover defenses.

(23 percent of the sample). These proposals, which are often brought by labor unions or institutional investors, are now common and frequently win significant shareholder votes. For example, shareholders have had real success in encouraging boards to eliminate staggered boards of directors and redeem so-called poison pill shareholder rights plans. One study reports that the incidence of staggered boards among S&P 1500 companies fell from 62 percent in 2002 to 47 percent by 2008.28

Companies that wish to exclude a shareholder proposal generally seek SEC approval. See Rule 14a-8(i). The SEC’s approval of such a request is called a “no-action letter,” since it takes the form of a letter stating that the SEC’s Division of Corporate Finance will not recommend disciplinary action against the company if the proposal is omitted. The shareholder proponent has the opportunity to respond to the request for a no-action letter.

**Corporate Governance Proposals.** An important governance question today is the extent of the shareholders’ ability to enact bylaws that limit the range of options open to the board in managing the firm. This question relates importantly to Rule 14a-8 because the SEC will not mandate access to the company’s proxy statement if, inter alia, the matter on which shareholder action is sought is not a proper subject of shareholder action under state law. We return to the issue of constraining the board’s discretion by shareholder bylaw proposals in greater detail at the end of this section, and again in our discussion of management’s latitude to defend against hostile takeovers in Chapter 13.

Less controversial corporate governance proposals often urge bylaw amendments on shareholders that would impose structural reforms on the board. We provide an example below: a Rule 14a-8 request by the Carpenters’ Pension Fund (CPF) to Hewlett-Packard (HP), requesting that the HP directors initiate a process to amend the company’s governance documents (certificate of incorporation or bylaws) so that director nominees shall be elected by the affirmative vote of the majority of votes cast at an annual meeting of shareholders.

**Carpenters’ Pension Fund Proposal and Supporting Statement**

October 7, 2005

BE IT RESOLVED: That the shareholders of Hewlett-Packard Company hereby request that the Board of Directors initiate the appropriate process to amend the company’s governance documents (certificate of incorporation or bylaws) to provide that director nominees shall be elected by the affirmative vote of the majority of votes cast at an annual meeting of shareholders.

SUPPORTING STATEMENT: ... Our Company presently uses the plurality vote standard to elect directors. This proposal requests that the Board initiate a change in the Company’s director election vote standard to provide that nominees for the board of directors must receive a majority of the vote cast in order to be elected or re-elected to the Board.

We believe that a majority vote standard in director elections would give shareholders a meaningful role in the director election process. Under the Company’s current standard, a nominee in a director election can be elected with as little as a single affirmative vote, even if a substantial majority of the votes cast are “withheld” from the nominee. The majority vote standard

Statutory and Regulatory Background
third party, or a copy of a current filing made with the Commission and furnished to the registrant, confirming such holder’s beneficial ownership; and

(2) Provide the registrant with an affidavit, declaration, affirmation or other similar document provided for under applicable state law identifying the proposal or other corporate action that will be the subject of the security holder’s solicitation or communication and attesting that:

(i) The security holder will not use the list information for any purpose other than to solicit security holders with respect to the same meeting or action by consent or authorization for which the registrant is soliciting or intends to solicit or to communicate with security holders with respect to a solicitation commenced by the registrant; and

(ii) The security holder will not disclose such information to any person other than a beneficial owner for whom the request was made and an employee or agent to the extent necessary to effectuate the communication or solicitation.

(d) The security holder shall not use the information furnished by the registrant pursuant to paragraph (a)(2)(ii) of this section for any purpose other than to solicit security holders with respect to the same meeting or action by consent or authorization for which the registrant is soliciting or intends to solicit or to communicate with security holders with respect to a solicitation commenced by the registrant; or disclose such information to any person other than an employee, agent, or beneficial owner for whom a request was made to the extent necessary to effectuate the communication or solicitation. The security holder shall return the information provided pursuant to paragraph (a)(2)(ii) of this section and shall not retain any copies thereof or of any information derived from such information after the termination of the solicitation.

(e) The security holder shall reimburse the reasonable expenses incurred by the registrant in performing the acts requested pursuant to paragraph (a) of this section.

§240.14a-8 Shareholder Proposals

This section addresses when a company must include a shareholder’s proposal in its proxy statement and identify the proposal in its form of proxy when the company holds an annual or special meeting of shareholders. In summary, in order to have your shareholder proposal included on a company’s proxy card, and included along with any supporting statement in its proxy statement, you must be eligible and follow certain procedures. Under a few specific circumstances, the company is permitted to exclude your proposal, but only after submitting its reasons to the Commission. We structured this section in a question-and-answer format so that
it is easier to understand. The references to “you” are to a shareholder seeking to submit the proposal.

(a) Question 1: What is a proposal? A shareholder proposal is your recommendation or requirement that the company and/or its board of directors take action, which you intend to present at a meeting of the company’s shareholders. Your proposal should state as clearly as possible the course of action that you believe the company should follow. If your proposal is placed on the company’s proxy card, the company must also provide in the form of proxy means for shareholders to specify by boxes a choice between approval or disapproval, or abstention. Unless otherwise indicated, the word “proposal” as used in this section refers both to your proposal, and to your corresponding statement in support of your proposal (if any).

(b) Question 2: Who is eligible to submit a proposal, and how do I demonstrate to the company that I am eligible?

(1) In order to be eligible to submit a proposal, you must have continuously held at least $2,000 in market value, or 1%, of the company’s securities entitled to be voted on the proposal at the meeting for at least one year by the date you submit the proposal. You must continue to hold those securities through the date of the meeting.

(2) If you are the registered holder of your securities, which means that your name appears in the company’s records as a shareholder, the company can verify your eligibility on its own, although you will still have to provide the company with a written statement that you intend to continue to hold the securities through the date of the meeting of shareholders. However, if like many shareholders you are not a registered holder, the company likely does not know that you are a shareholder, or how many shares you own. In this case, at the time you submit your proposal, you must prove your eligibility to the company in one of two ways:

(i) The first way is to submit to the company a written statement from the “record” holder of your securities (usually a broker or bank) verifying that, at the time you submitted your proposal, you continuously held the securities for at least one year. You must also include your own written statement that you intend to continue to hold the securities through the date of the meeting of shareholders; or

(ii) The second way to prove ownership applies only if you have filed a Schedule 13D (§240.13d-101), Schedule 13G (§240.13d-102), Form 3 (§249.103 of this chapter), Form 4 (§249.104 of this chapter) and/or Form 5 (§249.105 of this chapter), or amendments to those documents or updated forms, reflecting your ownership of the shares as of or before the date on which the one-year eligibility period begins. If you have filed one of these documents with the SEC, you may demonstrate your eligibility by submitting to the company:

(A) A copy of the schedule and/or form, and any subsequent amendments reporting a change in your ownership level;
B) Your written statement that you continuously held the required number of shares for the one-year period as of the date of the statement; and

C) Your written statement that you intend to continue ownership of the shares through the date of the company's annual or special meeting.

(c) Question 3: How many proposals may I submit? Each shareholder may submit no more than one proposal to a company for a particular shareholders' meeting.

(d) Question 4: How long can my proposal be? The proposal, including any accompanying supporting statement, may not exceed 500 words.

(e) Question 5: What is the deadline for submitting a proposal?

1) If you are submitting your proposal for the company's annual meeting, you can in most cases find the deadline in last year's proxy statement. However, if the company did not hold an annual meeting last year, or has changed the date of its meeting for this year more than 30 days from last year's meeting, you can usually find the deadline in one of the company's quarterly reports on Form 10-Q (§249.308a of this chapter) or 10-QSB (§249.308b of this chapter), or in shareholder reports of investment companies under §270.30d-1 of this chapter of the Investment Company Act of 1940. In order to avoid controversy, shareholders should submit their proposals by means, including electronic means, that permit them to prove the date of delivery.

2) The deadline is calculated in the following manner if the proposal is submitted for a regularly scheduled annual meeting. The proposal must be received at the company's principal executive offices not less than 120 calendar days before the date of the company's proxy statement released to shareholders in connection with the previous year's annual meeting. However, if the company did not hold an annual meeting the previous year, or if the date of this year's annual meeting has been changed by more than 30 days from the date of the previous year's meeting, then the deadline is a reasonable time before the company begins to print and mail its proxy materials.

3) If you are submitting your proposal for a meeting of shareholders other than a regularly scheduled annual meeting, the deadline is a reasonable time before the company begins to print and mail its proxy materials.

(f) Question 6: What if I fail to follow one of the eligibility or procedural requirements explained in answers to Questions 1 through 4 of this section?

1) The company may exclude your proposal, but only after it has notified you of the problem, and you have failed adequately to correct it. Within 14 calendar days of receiving your proposal, the company must notify you in writing of any procedural or eligibility deficiencies, as well as of the time frame for your response. Your response must be postmarked, or transmitted electronically, no later than 14 days from the date you received the company's notification. A company need not
provide you such notice of a deficiency if the deficiency cannot be remedied, such as if you fail to submit a proposal by the company’s properly determined deadline. If the company intends to exclude the proposal, it will later have to make a submission under §240.14a-8 and provide you with a copy under Question 10 below, §240.14a-8(j).

(2) If you fail in your promise to hold the required number of securities through the date of the meeting of shareholders, then the company will be permitted to exclude all of your proposals from its proxy materials for any meeting held in the following two calendar years.

(g) Question 7: Who has the burden of persuading the Commission or its staff that my proposal can be excluded? Except as otherwise noted, the burden is on the company to demonstrate that it is entitled to exclude a proposal.

(h) Question 8: Must I appear personally at the shareholders’ meeting to present the proposal?

(1) Either you, or your representative who is qualified under state law to present the proposal on your behalf, must attend the meeting to present the proposal. Whether you attend the meeting yourself or send a qualified representative to the meeting in your place, you should make sure that you, or your representative, follow the proper state law procedures for attending the meeting and/or presenting your proposal.

(2) If the company holds its shareholder meeting in whole or in part via electronic media, and the company permits you or your representative to present your proposal via such media, then you may appear through electronic media rather than traveling to the meeting to appear in person.

(3) If you or your qualified representative fail to appear and present the proposal, without good cause, the company will be permitted to exclude all of your proposals from its proxy materials for any meetings held in the following two calendar years.

(i) Question 9: If I have complied with the procedural requirements, on what other bases may a company rely to exclude my proposal?

(1) Improper under state law: If the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company’s organization;

Note to paragraph (i)(1): Depending on the subject matter, some proposals are not considered proper under state law if they would be binding on the company if approved by shareholders. In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise.

(2) Violation of law: If the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject;
Securities Exchange Act of 1934

Note to paragraph (i)(2): We will not apply this basis for exclusion to permit exclusion of a proposal on grounds that it would violate foreign law if compliance with the foreign law would result in a violation of any state or federal law.

(3) Violation of proxy rules: If the proposal or supporting statement is contrary to any of the Commission's proxy rules, including §240.14a-9, which prohibits materially false or misleading statements in proxy soliciting materials;

(4) Personal grievance; special interest: If the proposal relates to the redress of a personal claim or grievance against the company or any other person, or if it is designed to result in a benefit to you, or to further a personal interest, which is not shared by the other shareholders at large;

(5) Relevance: If the proposal relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business;

(6) Absence of power/authority: If the company would lack the power or authority to implement the proposal;

(7) Management functions: If the proposal deals with a matter relating to the company's ordinary business operations;

(8) Relates to election: If the proposal relates to a nomination or an election for membership on the company's board of directors or analogous governing body or a procedure for such nomination or election;

(9) Conflicts with company's proposal: If the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting;

Note to paragraph (i)(9): A company's submission to the Commission under this section should specify the points of conflict with the company's proposal.

(10) Substantially implemented: If the company has already substantially implemented the proposal;

(11) Duplication: If the proposal substantially duplicates another proposal previously submitted to the company by another proponent that will be included in the company's proxy materials for the same meeting;

(12) Resubmissions: If the proposal deals with substantially the same subject matter as another proposal or proposals that has or have been previously included in the company's proxy materials within the preceding 5 calendar years, a company may exclude it from its proxy materials for any meeting held within 3 calendar years of the last time it was included if the proposal received:

(i) Less than 3% of the vote if proposed once within the preceding 5 calendar years;
(ii) Less than 6% of the vote on its last submission to shareholders if proposed twice previously within the preceding 5 calendar years; or

(iii) Less than 10% of the vote on its last submission to shareholders if proposed three times or more previously within the preceding 5 calendar years; and

(13) Specific amount of dividends: If the proposal relates to specific amounts of cash or stock dividends.

(j) Question 10: What procedures must the company follow if it intends to exclude my proposal?

(1) If the company intends to exclude a proposal from its proxy materials, it must file its reasons with the Commission no later than 80 calendar days before it files its definitive proxy statement and form of proxy with the Commission. The company must simultaneously provide you with a copy of its submission. The Commission staff may permit the company to make its submission later than 80 days before the company files its definitive proxy statement and form of proxy, if the company demonstrates good cause for missing the deadline.

(2) The company must file six paper copies of the following:

(i) The proposal;

(ii) An explanation of why the company believes that it may exclude the proposal, which should, if possible, refer to the most recent applicable authority, such as prior Division letters issued under the rule; and

(iii) A supporting opinion of counsel when such reasons are based on matters of state or foreign law.

(k) Question 11: May I submit my own statement to the Commission responding to the company’s arguments? Yes, you may submit a response, but it is not required. You should try to submit any response to us, with a copy to the company, as soon as possible after the company makes its submission. This way, the Commission staff will have time to consider fully your submission before it issues its response. You should submit six paper copies of your response.

(l) Question 12: If the company includes my shareholder proposal in its proxy materials, what information about me must it include along with the proposal itself?

(1) The company’s proxy statement must include your name and address, as well as the number of the company’s voting securities that you hold. However, instead of providing that information, the company may instead include a statement that it will provide the information to shareholders promptly upon receiving an oral or written request.

(2) The company is not responsible for the contents of your proposal or supporting statement.

(m) Question 13: What can I do if the company includes in its proxy statement reasons why it believes shareholders should not vote in favor of my proposal, and I disagree with some of its statements?

(1) The company may elect to include in its proxy statement reasons why it believes shareholders should vote against your proposal. The
Additional Materials on Recent Developments
United States Court of Appeals
FOR THE DISTRICT OF COLUMBIA CIRCUIT

Argued April 7, 2011 Decided July 22, 2011

No. 10-1305

BUSINESS ROUNDTABLE AND CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

On Petition for Review of an Order of the Securities & Exchange Commission

Eugene Scalia argued the cause for petitioners. With him on the briefs were Amy Goodman, Daniel J. Davis, and Robin S. Conrad. Amar D. Sarwal entered an appearance.

Steven A. Engel, Ruth S. Epstein, and G. Eric Brunstad, Jr. were on the brief for amici curiae Investment Company Institute and Independent Directors Council in support of petitioners.
Shannon E. German was on the brief for amicus curiae State of Delaware in support of petitioners.

Randall W. Quinn, Assistant General Counsel, Securities and Exchange Commission, argued the cause for respondent. With him on the brief were David M. Becker, General Counsel, Jacob H. Stillman, Solicitor, Michael A. Conley, Deputy Solicitor, Michael L. Post, Senior Litigation Counsel, and Tracey A. Hardin, Senior Counsel.

Reuben A. Guttman was on the brief for amici curiae Law Professors in support of respondent.

Jeffrey A. Lamken, Christopher J. Wright, Timothy J. Simeone, Peter Mixon, and Robert M. McKenna, Attorney General, Office of the Attorney for the State of Washington, were on the brief for amici curiae Council of Institutional Investors, et al.

Before: SENTELLE, Chief Judge, GINSBURG and BROWN, Circuit Judges.

Opinion for the Court filed by Circuit Judge GINSBURG.

GINSBURG, Circuit Judge: The Business Roundtable and the Chamber of Commerce of the United States, each of which has corporate members that issue publicly traded securities, petition for review of Exchange Act Rule 14a-11. The rule requires public companies to provide shareholders with information about, and their ability to vote for, shareholder-nominated candidates for the board of directors. The petitioners argue the Securities and Exchange Commission promulgated the rule in violation of the Administrative Procedure Act, 5 U.S.C. § 551 et seq., because, among other reasons, the Commission failed
adequately to consider the rule's effect upon efficiency, competition, and capital formation, as required by Section 3(f) of the Exchange Act and Section 2(c) of the Investment Company Act of 1940, codified at 15 U.S.C. §§ 78c(f) and 80a-2(c), respectively. For these reasons and more, we grant the petition for review and vacate the rule.

I. Background

The proxy process is the principal means by which shareholders of a publicly traded corporation elect the company's board of directors. Typically, incumbent directors nominate a candidate for each vacancy prior to the election, which is held at the company's annual meeting. Before the meeting the company puts information about each nominee in the set of "proxy materials" — usually comprising a proxy voting card and a proxy statement — it distributes to all shareholders. The proxy statement concerns voting procedures and background information about the board's nominee(s); the proxy card enables shareholders to vote for or against the nominee(s) without attending the meeting. A shareholder who wishes to nominate a different candidate may separately file his own proxy statement and solicit votes from shareholders, thereby initiating a "proxy contest."

Rule 14a-11 provides shareholders an alternative path for nominating and electing directors. Concerned the current process impedes the expression of shareholders' right under state corporation laws to nominate and elect directors, the Commission proposed the rule, see Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024, 29,025-26 (2009) (hereinafter Proposing Release), and adopted it with the goal of ensuring "the proxy process functions, as nearly as possible, as a replacement for an actual in-person meeting of shareholders," 75 Fed. Reg. 56,668, 56,670 (2010)
(hereinafter Adopting Release). After responding to public comments, the Commission amended the proposed rule and, by a vote of three to two, adopted Rule 14a-11. Id. at 56,677. The rule requires a company subject to the Exchange Act proxy rules, including an investment company (such as a mutual fund) registered under the Investment Company Act of 1940 (ICA), to include in its proxy materials "the name of a person or persons nominated by a [qualifying] shareholder or group of shareholders for election to the board of directors." Id. at 56,682–83, 56,782/3.

To use Rule 14a-11, a shareholder or group of shareholders must have continuously held "at least 3% of the voting power of the company's securities entitled to be voted" for at least three years prior to the date the nominating shareholder or group submits notice of its intent to use the rule, and must continue to own those securities through the date of the annual meeting. Id. at 56,674–75. The nominating shareholder or group must submit the notice, which may include a statement of up to 500 words in support of each of its nominees, to the Commission and to the company. Id. at 56,675–76. A company that receives notice from an eligible shareholder or group must include the proffered information about the shareholder(s) and his nominee(s) in its proxy statement and include the nominee(s) on the proxy voting card. Id. at 56,676/1.

The Commission did place certain limitations upon the application of Rule 14a-11. The rule does not apply if applicable state law or a company's governing documents "prohibit shareholders from nominating a candidate for election as a director." Id. at 56,674/3. Nor may a shareholder use Rule 14a-11 if he is holding the company's securities with the intent of effecting a change of control of the company. Id. at 56,675/1. The company is not required to
include in its proxy materials more than one shareholder nominee or the number of nominees, if more than one, equal to 25 percent of the number of directors on the board. *Id.* at 56,675/2.

The Commission concluded that Rule 14a-11 could create “potential benefits of improved board and company performance and shareholder value” sufficient to “justify [its] potential costs.” *Id.* at 56,761/1. The agency rejected proposals to let each company’s board or a majority of its shareholders decide whether to incorporate Rule 14a-11 in its bylaws, saying that “exclusive reliance on private ordering under State law would not be as effective and efficient” in facilitating shareholders’ right to nominate and elect directors. *Id.* at 56,759–60. The Commission also rejected the suggestion it exclude investment companies from Rule 14a-11. *Id.* at 56,684/1. The two Commissioners voting against the rule faulted the Commission on both theoretical and empirical grounds. See Commissioner Troy A. Paredes, Statement at Open Meeting to Adopt the Final Rule Regarding “Proxy Access” (Aug. 25, 2010), available at http://www.sec.gov/news/speech/2010/spch082510tap.htm; Commissioner Kathleen L. Casey, Statement at Open Meeting to Adopt Amendments Regarding “Proxy Access” (Aug. 25, 2010), available at http://www.sec.gov/news/speech/2010/spch082510klc.htm (faulting Commission for failing to act “on the basis of empirical data and sound analysis”).

* When several nominating shareholders are eligible to use Rule 14a-11, “the nominating shareholder or group with the highest percentage of the company’s voting power would have its nominees included in the company’s proxy materials.” 75 Fed. Reg. at 56,675/2.
The petitioners sought review in this court in September 2010. The Commission then stayed the final rule, which was to have been effective on November 15, pending the outcome of this case.

II. Analysis

Under the APA, we will set aside agency action that is “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.” 5 U.S.C. § 706(2)(A). We must assure ourselves the agency has “examine[d] the relevant data and articulate[d] a satisfactory explanation for its action including a rational connection between the facts found and the choices made.” Motor Vehicle Mfrs. Ass’n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983) (internal quotation marks omitted). The Commission also has a “statutory obligation to determine as best it can the economic implications of the rule.” Chamber of Commerce v. SEC, 412 F.3d 133, 143 (D.C. Cir. 2005).

Indeed, the Commission has a unique obligation to consider the effect of a new rule upon “efficiency, competition, and capital formation,” 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a-2(c), and its failure to “apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation” makes promulgation of the rule arbitrary and capricious and not in accordance with law. Chamber of Commerce, 412 F.3d at 144; Pub. Citizen v. Fed. Motor Carrier Safety Admin., 374 F.3d 1209, 1216 (D.C. Cir. 2004) (rule was arbitrary and capricious because agency failed to consider a factor required by statute).

The petitioners argue the Commission acted arbitrarily and capriciously here because it neglected its statutory responsibility to determine the likely economic consequences
of Rule 14a-11 and to connect those consequences to efficiency, competition, and capital formation. They also maintain the Commission’s decision to apply Rule 14a-11 to investment companies is arbitrary and capricious.

We agree with the petitioners and hold the Commission acted arbitrarily and capriciously for having failed once again — as it did most recently in American Equity Investment Life Insurance Company v. SEC, 613 F.3d 166, 167–68 (D.C. Cir. 2010), and before that in Chamber of Commerce, 412 F.3d at 136 — adequately to assess the economic effects of a new rule. Here the Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters. For these and other reasons, its decision to apply the rule to investment companies was also arbitrary. Because we conclude the Commission failed to justify Rule 14a-11, we need not address the petitioners’ additional argument the Commission arbitrarily rejected proposed alternatives that would have allowed shareholders of each company to decide for that company whether to adopt a mechanism for shareholders’ nominees to get access to proxy materials.

A. Consideration of Economic Consequences

In the Adopting Release, the Commission predicted Rule 14a-11 would lead to “[d]irect cost savings” for shareholders in part due to “reduced printing and postage costs” and reduced expenditures for advertising compared to those of a “traditional” proxy contest. 75 Fed. Reg. at 56,756/2. The Commission also identified some intangible, or at least less readily quantifiable, benefits, principally that the rule “will
Statement by SEC Chairman Mary L. Schapiro on Proxy Access Litigation

FOR IMMEDIATE RELEASE
2011-179

Washington, D.C., Sept. 6, 2011 - The Securities and Exchange Commission today confirmed that it is not seeking rehearing of the decision by the U.S. Court of Appeals in Washington, D.C. vacating a Commission rule, Rule 14a-11, which would have required companies to include shareholders' director nominees in company proxy materials in certain circumstances. Nor will the SEC seek Supreme Court review.

Chairman Mary L. Schapiro issued the following statement:

"I firmly believe that providing a meaningful opportunity for shareholders to exercise their right to nominate directors at their companies is in the best interest of investors and our markets. It is a process that helps make boards more accountable for the risks undertaken by the companies they manage. I remain committed to finding a way to make it easier for shareholders to nominate candidates to corporate boards.

"At the same time, I want to be sure that we carefully consider and learn from the Court's objections as we determine the best path forward. I have asked the staff to continue reviewing the decision as well as the comments that we previously received from interested parties."

# # #

Last year, when the Commission adopted Rule 14a-11, it also adopted amendments to Rule 14a-8, the shareholder proposal rule. Under those amendments, eligible shareholders are permitted to require companies to include shareholder proposals regarding proxy access procedures in company proxy materials. Through this procedure, shareholders and companies have the opportunity to establish proxy access standards on a company-by-company basis -- rather than a specified standard like that contained in Rule 14a-11.

Although the amendments to Rule 14a-8 were not challenged in the litigation, the Commission voluntarily stayed the effective date of those amendments at the time it stayed the effective date of Rule 14a-11. The Commission's stay order provides that the stay of the effective date of the amendments to Rule 14a-8 and related rules will expire without further Commission action when the court's decision is finalized, which is expected to be September 13. Accordingly, absent further Commission action, Rule 14a-8 will go into effect and a notice of the effective date of the amendments will be published.

# # #
Additional Materials on Recent Developments