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RESPONSE

PROXY REGULATION IN SEARCH OF A PURPOSE: A REPLY TO PROFESSOR RYAN

*George W. Dent, Jr.**

Changing conditions often force us to rethink the role of a law. Professor Ryan's scholarly article, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*,¹ underscores this need. His article is useful for both its successes and its failures. Its principal failure is its inability to identify a general justification for the rule. This is helpful; the failure of an intelligent and determined advocate to find a persuasive defense of the rule confirms that no defense is possible. The article succeeds principally in showing how institutional investors have recently used the rule in ways that put the rule in a new light. The new developments demand a response from the rule's critics.² This reply argues that Professor Ryan is right in concluding that the new developments justify a role for the rule, but that this role must be more narrowly defined than it has been by Professor Ryan.

I. LEGISLATIVE HISTORY OF SECTION 14(A)

Professor Ryan's Herculean effort to plumb the legislative his-

* Professor of Law, New York Law School. B.A. 1969, J.D. 1973, Columbia University; LL.M. 1981, New York University. Professor Patrick J. Ryan's article, in which he offered justifications for SEC rule 14a-8, appeared in Volume 23, Number 1 of the *Georgia Law Review*, Fall 1988. See *infra* note 1. Rule 14a-8 permits qualified shareholders, at no cost to themselves, to include proposals in the corporation's proxy solicitation materials. 17 C.F.R. § 240.14a-8 (1988).

¹ 23 GA. L. REV. 97 (1988).

² The author is one of those critics. See Dent, *SEC Rule 14a-8: A Study in Regulatory Failure*, 30 N.Y.L. SCH. L. REV. 1 (1985). See also Liebler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425 (1984).

tory of the Exchange Act makes all the more impressive the lack of results. He finds that Congress did intend proxy regulation under Section 14 to change corporate governance and to promote "fair corporate suffrage."³ He sees two models of shareholder action reflected in the legislative history—shareholders as monitors and shareholders as decisionmakers.⁴ He is undoubtedly correct that Congress intended proxy regulation to affect corporate governance, but this begs the questions how and why Congress wanted this to happen.

The legislative history's references to shareholder rights and corporate suffrage are few and vague. Read in context, most deal with disclosure. An oft-quoted passage in the House Report states that "[f]air corporate suffrage is an important right."⁵ "Fair corporate suffrage" is not defined here or anywhere else, but the passage refers to "adequate disclosure," "adequate explanation," and "fairly informing the stockholders."⁶ The same passage refers to "preventing the recurrence of abuses which have frustrated the free exercise of the voting rights of stockholders."⁷ The specific abuses mentioned in the legislative history all deal with misleading disclosures or total nondisclosure to shareholders, generally by managements.⁸

Professor Ryan also makes much of a statement in the Senate Report about "major questions of policy, which are decided at stockholders' meetings."⁹ However, the Report speaks only of "adequate knowledge" so that shareholders may be "enlightened" about these questions, not initiate them, and complains of solicitation of proxies "without explanation to the stockholder of the real nature of the matters for which authority to cast his vote is sought."¹⁰ Similarly, the statement in the Senate Hearings that a corporation and its shareholders are "partners in its business" is

³ Ryan, *supra* note 1, at 135-36, 145-46, 164.

⁴ *Id.* at 140, 146, 165-66, 178-79.

⁵ H.R. REP. No. 1838, 73d Cong., 2d Sess. 13 (1934).

⁶ *Id.* at 13-14.

⁷ *Id.* at 14.

⁸ The Senate Report, for example, complains of "unscrupulous corporate officials seeking to retain control of the management by concealing and distorting facts." S. REP. No. 1455, 73d Cong., 2d Sess. 77 (1934). The Report specifically describes one instance of nondisclosure of a management conflict of interest. *Id.* at 75-76. See also text accompanying *infra* note 10.

⁹ Ryan, *supra* note 1, at 137 (quoting S. REP. No. 1455, 73d Cong., 2d Sess. 74 (1934)).

¹⁰ S. REP. No. 1455, 73d Cong., 2d Sess. 74 (1934).

used only to support the conclusion that corporations should give "definite information at frequent enough periods so that the public . . . might with more intelligence buy its shares."¹¹

Beyond this Professor Ryan finds only a handful of vague comments scattered throughout the voluminous legislative history. These comments, mostly made by Thomas Corcoran, a drafter of the bill but not a member of Congress, speak of "the protection of corporate outsiders from corporate insiders"¹² and of "prevent[ing] the great mass of unorganized stockholders and bondholders from being at the mercy of . . . management."¹³ It is not clear what Mr. Corcoran meant by or what his congressional audience understood from these comments.

Statements in the legislative history supporting the use of proxy regulation to interfere with corporate governance are not only weak and vague but are also opposed by indications that Congress intended to avoid or limit such interference. As Professor Ryan recognizes, Congress expressly denied that the Act could be interpreted as "authorizing the [SEC] to interfere with the management of the affairs of an issuer."¹⁴ Professor Ryan construes this denial as applying only to "direct SEC management and control of a corporation, or of substantive review of management decisions by the SEC."¹⁵ Although it is true that Congress eschewed direct SEC interference in corporate governance, it does not follow that every

¹¹ *Stock Exchange Practices: Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 Before the Senate Comm. on Banking and Currency, 73d Cong., 2d Sess. 6674-75 (1934) [hereinafter Senate Exchange Act Hearings] (remarks of Richard Whitney, then president of the New York Stock Exchange).*

¹² *Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 132 (1934) [hereinafter House Exchange Act Hearings] (remarks of Thomas Corcoran); Senate Exchange Act Hearings, supra note 11, at 6518 (testimony of Mr. Corcoran).*

¹³ *House Exchange Act Hearings, supra note 12, at 138 (remarks of Mr. Corcoran).* Since bondholders do not vote with shareholders, the reference to bondholders reinforces the conclusion that Mr. Corcoran was thinking only of disclosure.

¹⁴ A proposed amendment stating this was therefore eliminated as unnecessary. H.R. REP. NO. 1838, 73d Cong., 2d Sess. 35 (1934). See also S. REP. NO. 792, 73d Cong., 2d Sess. 10 (1934) (denying that the Act empowers the SEC to "interfere in the management of corporations"). These statements are consistent with President Roosevelt's avowed intention that the securities laws "protect the public with the least possible interference to honest business." H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933). See generally Dent, *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865, 903-09 (1983).

¹⁵ Ryan, *supra* note 1, at 138.

form of indirect interference was permitted, or that rule 14a-8 is only an indirect interference.

Since disclosure is the Exchange Act's "fundamental regulatory model,"¹⁶ it would not be unreasonable to infer that the intended protection and prevention were to come solely from injecting disclosure into the existing scheme of state corporate law. At the least, Congress had no idea of how, if at all, it wanted the Exchange Act to affect corporate governance except through disclosure. Clearly, Congress did not envision shareholder proposals, or anything that even remotely resembles shareholder proposals.

Phrases used by Professor Ryan and other defenders of the rule to describe the regime envisioned by Congress must be viewed in the light of this legislative history. Professor Ryan understandably distances himself from such terms as "corporate democracy"; because of their vagueness, these terms more hinder than facilitate analysis.¹⁷ Unfortunately, Professor Ryan's proposed substitutes, seeing shareholders as "monitors" and "decisionmakers,"¹⁸ do little better. Congress never used these terms, and the preceding discussion shows that Congress did not intend any specific shareholder roles that would give these terms content. Given Congress's emphasis on disclosure and its desire to limit interference with corporate governance, one might reasonably conclude that if Congress meant shareholders to be "monitors" and "decisionmakers," it meant them to be so only as they already were under state law, but with the added benefit of full disclosure. While this is not the only possible reading of the Act, any broader reading must be cautiously undertaken.

II. RULE 14A-8 AND "TRADITIONAL" SHAREHOLDER PROPOSALS

Analyzing the legislative history of the Exchange Act is no more than the first step to determining the propriety of rule 14a-8. The next steps must be to analyze how shareholder proposals function and to ascertain whether that function can be squared with the purposes of the Act. The rule can survive even a narrow reading of the Act if the function of the rule falls within the narrowly defined purposes of the Act. Unfortunately, Professor Ryan does not

¹⁶ *Id.* at 125. See also Dent, *supra* note 14, at 903-05.

¹⁷ See Ryan, *supra* note 1, at 102, 168, 174.

¹⁸ *Id.* at 140, 146.

take these steps, at least with respect to "traditional"¹⁹ proposals. He seems to assume that the success of institutional proposals warrants the entire rule.²⁰ The justification for traditional proposals, however, is not at all self-evident.

Reading the Act as strictly limited to disclosure does not necessarily defeat the rule. The initial rationale for the rule was that shareholders were entitled, strictly as a matter of disclosure, to be informed of proposals that management knew would be offered at the shareholders' meeting.²¹ In practice, however, this rationale proved so weak that the SEC and supporters of the rule now rarely mention it. The problem with the disclosure explanation is that only *material* information must be disclosed,²² but the feeble support obtained by traditional proposals showed that shareholders did not consider them material.²³

Apparently recognizing this, Professor Ryan follows other defenders of the rule in seeking further justifications. He defends the rule as a "consultative mechanism" that notifies managements of shareholder views, forces managements to articulate reasons for their policies, and thereby makes managements more "legitimate."²⁴ Like other arguments for the rule, these do not weather close scrutiny. If shareholder proposals notify managements of shareholder views, the clear message delivered for over four decades was that shareholders do not support shareholder proposals. Although management's articulation of reasons for its policies is by itself desirable, it is not costless. Including shareholder proposals

¹⁹ By "traditional" I mean all proposals other than institutional proposals, which deal primarily with takeover defenses. *See id.* at 101, 111 (describing "the typical rule 14a-8 proposal"). The line between the two is not sharp. *See infra* note 35.

²⁰ *See* Ryan, *supra* note 1, at 104 ("rule 14a-8 requires no significant amendments at this time"), 136, 147, 160.

²¹ *See SEC Proxy Rules: Hearings on H.R. 1493, H.R. 1821 & H.R. 2019 Before the House Comm. on Interstate and Foreign Commerce, 78th Cong., 1st Sess. 169-70 (1943); 5 SEC Ann. Rep. 60-62 (1939); Dean, Non-Compliance with Proxy Regulations—Effect on Ability of Corporations To Hold Valid Meetings, 24 CORNELL L.Q. 483, 499 (1939).*

²² Rule 14a-9 is typical of the securities laws in forbidding any proxy statement that "is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading." 17 C.F.R. § 240.14a-9 (1988).

²³ *See* Dent, *supra* note 2, at 4-8.

²⁴ Ryan, *supra* note 1, at 111-12. Professor Ryan also discusses corporate legitimacy in greater depth at 168-71, 179-80. Commendably, he eschews some other justifications for the rule, such as the tendency to embarrass management into changing its policies.

in proxy statements entails some financial expense,²⁵ and time taken by busy executives to explain policies diminishes attention to other matters. The tiny handful of small investors who submit most proposals²⁶ have no special expertise in deciding how managers should allocate their time, and it is a mockery of shareholder democracy to permit them to do so. Thus, criticism of rule 14a-8 is neither managerialist nor anti-shareholder. Most shareholders have no love for the rule. Indeed, supporters of the rule opposed suggestions that shareholders vote on whether to have shareholder proposals in their firm's proxy statements; the supporters realized that shareholders would probably vote to eliminate or severely restrict shareholder proposals.²⁷

As for that will-o'-the-wisp, legitimacy, there is no evidence that Congress intended to promote it by the Exchange Act (unless such an intent is to be found in the *Zeitgeist* of the early 1930s) or even of what Congress would have understood by legitimacy. But even assuming that Congress wanted to enhance legitimacy—and however one defines legitimacy—it is hard to see how rule 14a-8 advances it. If the vote on a shareholder proposal establishes legitimacy, presumably the proponents should accept the results of that vote. As Professor Ryan recognizes,²⁸ however, most proponents do not accept shareholder rejection of their proposals but keep submitting the same proposals over and over. Indeed, habitual proponents often admit—or rather brag—that their objective is not to win a shareholder vote but to gain publicity for their pet causes and to embarrass management into changing its policies.²⁹ Efforts to embarrass management do not buttress its legitimacy but undermine it.

In sum, analysis of the functioning of rule 14a-8 in light of the legislative history of section 14(a) reveals no justification for traditional proposals. These proposals do not disclose material information. Neither do they enhance corporate governance, "fair

²⁵ See Dent, *supra* note 2, at 14-16.

²⁶ As of 1982, nearly half of all shareholder proposals were submitted by just five investors, two of whom were brothers acting as a team. See *id.* at 12. Changes in the rule and in investor behavior over the last few years have undoubtedly reduced this concentration, but most proposals are still submitted by a handful of habitual proponents.

²⁷ See *id.* at 12-13.

²⁸ Ryan, *supra* note 1, at 121.

²⁹ See Dent, *supra* note 2, at 20-22.

corporate suffrage," "corporate democracy," corporate "legitimacy," or the roles of shareholders as monitors and decisionmakers in any reasonable understanding of these terms. Despite this, the rule has become firmly established over the last fifty years; it is unlikely that a court would invalidate it now. The SEC, however, could well conclude that traditional proposals are illegitimate. In particular, the Commission could properly decide that where the legislative authority for a rule is so weak, the policy basis for the rule must be strong. Lacking such a basis, the SEC should repeal the rule with respect to traditional proposals.

III. INSTITUTIONAL SHAREHOLDER PROPOSALS

Standing apart from the traditional shareholder proposal is the institutional proposal opposing anti-takeover measures. As Professor Ryan shows, this development is new, having evolved after the major critiques of rule 14a-8.³⁰ Unlike most traditional proposals, institutional proposals deal with matters of unquestioned importance to shareholders and attract very substantial shareholder support. Even under a narrow reading of section 14(a), it is easy to justify using rule 14a-8 for this type of proposal. Even if such concepts as "fair corporate suffrage" and "shareholder democracy"—or Professor Ryan's competing concepts of shareholders as monitors and decisionmakers—are vague, they surely include a right to vote on matters where a majority might well disagree with and (state law permitting) overrule management. It is unnecessary to resort to such dubious policies as forcing managers to explain their policies or promoting managers' "legitimacy."

It is not even necessary to resort to any corporate governance explanation. As noted, the rule was originally explained on disclosure grounds; shareholders were entitled to know about resolutions that management knew were to be presented at the shareholders' meeting.³¹ This explanation fell into disfavor when the feeble support for traditional proposals revealed that shareholders did not consider them material. The broad support for many institutional proposals, however, shows that shareholders do consider them material. Thus, application of 14a-8 to institutional proposals can be grounded solely on a narrow disclosure theory of section 14(a).

³⁰ Ryan, *supra* note 1, at 147-63.

³¹ See *supra* note 21.

One could argue that even institutional proposals do not deserve the treatment granted by rule 14a-8. If institutional investors have a large stake in takeovers, arguably they should be willing to pay the cost of soliciting proxies to oppose takeover defenses. In fact, many campaigns against takeover defenses have been funded by institutional investors.³² The argument for barring them by repealing 14a-8, however, ignores the economics of shareholder voting. Even an institution whose holdings in a portfolio company run to tens of millions of dollars still typically owns only a tiny fraction of the company's stock. If the institution undertakes a proxy solicitation, it will enjoy only a small part of any resulting benefit, assuming it wins. It must bear the entire cost of the solicitation, though, unless it can persuade some other stockholders to share the burden, and even then it inevitably bears a disproportionate share of the cost. In short, shareholders face a collective action problem. This leads to "rational apathy" of shareholders—the attitude that the proper expenditure of time and effort on proxy voting is zero, even for a large shareholder.³³ Rule 14a-8 can properly be used to overcome this collective action problem.

Unfortunately, Professor Ryan gives no more refined analysis than to conclude that the arrival of institutional proposals justifies the entire rule.³⁴ It is true that, having found a baby in the rule, we should not throw it out with the bath water. However, it does not follow that we must also keep the bath water in order to preserve the baby. Rather, we need an analysis that separates the two.

At least three approaches come to mind. One would permit shareholder proposals only in opposition to anti-takeover devices since these have generated the most shareholder support. This standard might be hard to define, however.³⁵ Also, not all pro-takeover proposals command substantial support. Support varies according to the substance of the proposal, the identity and skill of the proponents, and the popularity and skill of management. More important, corporate governance seems to be entering a new phase. The explosion of mergers, leveraged buyouts, and hostile takeovers

³² See generally Ryan, *supra* note 1, at 155-60.

³³ The term "rational apathy" was first coined by Dean Clark. Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776, 779-83 (1979).

³⁴ See Ryan, *supra* note 1, at 104, 136, 147, 160.

³⁵ Many matters are not easily characterized as dealing or not dealing with takeovers, especially since the nature of takeover and defensive tactics changes constantly.

has raised the stakes for all players. The growth of institutional investors has introduced a new shareholder, more willing and able than the individual shareholder to challenge the dominance of management. As institutional investors play a growing role they may move into other areas of corporate governance. This possibility should not be cut off.

The SEC could instead limit the rule by substantially raising the amount of stock that must be held by proponents, perhaps to \$1 million. This would leave the rule open to institutional investors while closing it to gadflies. However, this might seem undemocratic. Further, the validity of a shareholder proposal depends on its support, not on the size of the proponent's holdings.

It would, therefore, be better to take a third approach and condition submission of any proposal upon the posting of a bond to cover the corporation's costs, with the bond to be returned if the proposal garners a respectable level of shareholder support, perhaps a minimum of twenty percent. This approach would distinguish among proposals on the basis of their likely support. The costs of a 14a-8 solicitation are not so great as to deter substantial shareholders with the fear that they might occasionally guess wrong and have to forfeit the bond.

Winnowing out unpopular proposals would save corporations a little money, but would also pay a more important dividend—increasing shareholder interest in proxy voting. The triviality and lack of support of most shareholder proposals now exacerbates “rational apathy.” Shareholders tend to follow the Wall Street Rule—sell your stock or vote with management—because they know they oppose most shareholder resolutions and cannot easily identify the few they would support. Eliminating unpopular proposals might not only induce investors to pay closer attention to shareholder resolutions but also weaken their strong presumption in favor of management.

Requiring the posting of a bond would narrow the availability of rule 14a-8, but the emergence of institutional shareholder proposals also suggests the desirability of broadening the rule in certain other respects. A bond would be an adequate screening device and should therefore obviate the devices now used to screen out trivial proposals, such as the requirements that the proponent own stock worth at least \$1000 and that any similar proposal previously sub-

mitted must have received a specified level of support.³⁶ The rule also currently bars proposals opposing management resolutions.³⁷ Thus, if management proposes a shark repellent (that is, an anti-takeover charter amendment), investors cannot use rule 14a-8 to oppose it; they must first use other weapons and only later, if those fail, use 14a-8 for a precatory proposal asking management to rescind it. This should be changed. If the rule were limited as suggested above, it would then make sense to remove the exclusion for proposals opposing management resolutions.

Perhaps more important, rule 14a-8 currently excludes proposals relating to elections to corporate offices.³⁸ Commentators have noted the anomaly that the rule excludes the most significant shareholder function in corporate governance—the election of directors.³⁹ The principal reason for the exclusion is that without it firms might be forced to list as candidates innumerable small investors with no significant support. Requiring a bond that would be refunded only if the candidate obtains twenty percent of the vote could avert this problem and give a boost to serious challengers.

Reform would be politically difficult. Rule 14a-8 has always been supported by the few but active investors whose pet projects are subsidized by the rule. Although managers dislike the rule, they have made little effort to repeal it both because they viewed repeal as politically unrealistic and because the costs of the rule are not great. A narrower rule that would spotlight significant proposals would be opposed not only by the gadflies whom it would exclude, but also by managers, who would be threatened by it. For managers, the current rule that buries serious proposals in a mass of trivia, is probably preferable.

The burgeoning activism of institutional investors also requires reconsideration of securities regulation beyond rule 14a-8. Within the proxy rules, the SEC could consider measures to facilitate institutional activity, such as easing the rules against proxy solicitations without filing a proxy statement.⁴⁰ The Commission could

³⁶ Rule 14a-8(a)(1)(i), 17 C.F.R. § 240.14a-8(a)(1)(i) (1988); rule 14a-8(c)(12), 17 C.F.R. § 240.14a-8(c)(12) (1988).

³⁷ Rule 14a-8(c)(9), 17 C.F.R. § 240.14a-8(c)(9) (1988).

³⁸ Rule 14a-8(c)(8), 17 C.F.R. § 240.14a-8(c)(8) (1988).

³⁹ See M. EISENBERG, *THE STRUCTURE OF THE CORPORATION* 111 (1976).

⁴⁰ See rule 14a-2(b)(1), 17 C.F.R. § 240.14a-2(b)(1) (1988) (any proxy solicitation ad-

also require secret ballots so that managers cannot punish independent institutional shareholders.⁴¹ Outside the proxy rules, the SEC should consider other steps, such as providing shareholders who act in concert safe harbors from section 13(d) and from controlling person liability.

The impact of institutional investor activism on corporate governance also needs to be pondered more generally. As Professor Ryan notes, managers view institutions warily, and at least some public shareholders do also. I, for one, regard the growing assertiveness of institutional investors as highly salutary and as holding the potential to solve the central problem of corporate governance—the separation of ownership and control.⁴² Others disagree. Professor Ryan has helped to advance the inquiry by his able examination of how institutional investors have transformed the role of rule 14a-8.

dressed to more than 10 shareholders requires the filing of a proxy statement).

⁴¹ Such punishment is common and takes many forms. See Dent, *Toward Unifying Ownership and Control in the Public Corporation*, 1989 Wis. L. Rev. ____ (forthcoming).

⁴² See *id.*