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## Shareholder Proxy Fight Expenses

Lawrence D. Stifel\*

CORPORATE DEMOCRACY IS REAL only to the extent that the security holder is enfranchised to participate effectively in the affairs of the enterprise—especially in the selection of its directors. Much shareholder suffrage in the modern corporation is merely nominal, because the wide dispersion of ownership compels the shareholder to exercise his voting privilege by proxy. Management often presents him with the right to *elect* but not to *select* directors.

Participation in the selection of directors of publicly held corporations requires expression through a proxy statement and involves costs of solicitation. Case decisions have firmly established management's right to use the corporate treasury for the proxy costs of a statement of its slate of candidates for directors;<sup>1</sup> the rationale being that management and incumbent directors have a positive duty to inform the shareholders and to encourage voting. Dissident shareholder groups, on the other hand, have normally been required to bear their own proxy expenses. Their active engagement in major corporate elections has been limited to a few spectacular examples.

There is no statutory authority, either federal or state, to indicate how shareholder proxy expenses shall be borne. Inquiries were addressed by the writer to the Secretaries of State of the States of the United States and of its territories, and the 72% return indicated neither statutes, rules nor regulations on the subject in the respondents' jurisdictions.

Nevertheless, recent case law has permitted successful insurgent stockholders to gain reimbursement of their proxy expenses from the corporation. These cases, as well as the uncertainty and inadequacy of their application, require examination.

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<sup>1</sup> The leading American case is *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 20 Del. Ch. 78, 171 A. 226 (1934), following *Peel v. London and North Western R. R. Co.*, 1 Ch. Div. 5 (1907).

### Background

The corporate proxy device was not recognized at common law, for the shareholder's voting privilege was a property right, considered too personal to be delegated.<sup>2</sup> "Where a corporation will pass any interest, the common law will not suffer the members of the corporation to give their assent by proctors or substitutes."<sup>3</sup> But commercial necessity dictated the separation of ownership and management, and by the 18th century voting by proxy was sanctioned by charter provisions and state legislation.<sup>4</sup>

The proxy has made the traditional legal and economic view of the shareholder as sovereign theoretically compatible with the divorce of management into a separate group. But with the rapid industrial growth of this century and its attendant increase in security holdings, a new type of mass corporate electorate has developed; today totalling eight and one-half million individuals.<sup>5</sup> The new shareholders, geographically scattered and possessing only fractional interests, are more concerned with the dividend rate than with decisions affecting the future management of the enterprise.

Managers have become the stewards of the corporate assets, conditioned of course upon continued shareholder approval. However, this approval has become largely perfunctory as management's access to shareholders' lists, connections with financial circles, and use of corporate funds gave to management control of the proxy machinery and, in a large segment of the economy, control over the corporation itself. The natural tendency of management to perpetuate itself in power is aided by such legislation as that proposed in the Model Business Corporation Act. It has been described by some eminent observers as "an invitation to irresponsibility."<sup>6</sup> "It is easier to upset a

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<sup>2</sup> 5 Fletcher, *Cyc. Law of Private Corporations*, 119 (1952).

<sup>3</sup> Davies Rep. 116 (1607) as quoted in *Axe, Corporate Proxies*, 41 Mich. L. Rev. 38, 39 (1942).

<sup>4</sup> *Id.*, at 38-50.

<sup>5</sup> *Aranow and Einhorn, Proxy Contests for Corporate Control* (1957), introduction by J. Sinclair Armstrong at xxiii.

<sup>6</sup> One study indicated control was exercised by management in 44% of the 200 largest non-financial corporations. Berle and Means, *The Corporation and Private Property* 94 (1933). As to the Model Act, see 1 Oleck, *Modern Corporation Law*, 104 (1958), citing the much discussed article: Harris, *The Model Business Corporation Act; An Invitation to Irresponsibility*, 50 *Northwestern U. L. R.* 1 (1955).

Ministry than a Board of Directors", quipped an English writer.<sup>7</sup>

If the interests of the owner-shareholders and the manager-stewards coincide, the system is at least practically acceptable; but the close scrutiny of the thirties revealed that the interests were not necessarily identical.<sup>8</sup> Types of management behavior were often detrimental to ownership interests, and the shareholders were often both unaware and impotent. Realization of this condition prompted national legislation under the administration of the Securities Exchange Commission, addressed to the problems of corporation excesses. Apparently the Model Corporation Act was a kind of counter to this national legislation.

Section 14 of the Securities Exchange Act of 1934 empowered the S. E. C. to prescribe proxy solicitation rules which it considered "necessary or appropriate in the public interest or for the protection of investors." The S. E. C. restricted its first regulations to the promotion of full and accurate disclosure of data on the proxy forms, adhering to the express objective of the Securities Act of 1933, rather than attempting to restore the shareholders' power vis-a-vis management. Communications were improved by Section 14, but the shareholders were still limited in their franchise to the proposals and candidates management presented to them.

In 1942, after continual revision and amendment, the Section 14 Proxy Rules were expanded to permit security holders to use the management proxy statement in order to present proposals of a proper corporate nature plus a supporting argument to the shareholders for vote.<sup>9</sup> Holders of securities traded on the national securities exchanges were given a tangible means of expression in corporate affairs. Shareholders, however, were still barred from nominating directors by an express prohibition concerning such use of Rule X-14A-8 and the mounting costs of proxy solicitation. Unlisted securities (i.e., in the great majority of corporations), still receive very little aid insofar as proxies and other matters are concerned, under the federal securities laws.

[Note that S. E. C. Rule X-14A-1 et seq. now is Rule 240.14a-1 et seq. See, Brey, A Synopsis of the Proxy Rules of the S. E. C., 26 U. Cinc. L. R. 58 (1957).]

<sup>7</sup> Parkinson, *Scientific Investment* 134 (1932), as quoted in Loss, *Securities Regulation* 522 (1951).

<sup>8</sup> Berle and Means, *op. cit. supra* n. 6, at 119-125.

<sup>9</sup> Rule X-14A-8.

### Case Development

In 1950, *Steinberg v. Adams*<sup>10</sup> was decided, permitting opposing shareholders in a proxy contest to reimburse themselves from the corporate treasury, if they were successful and acquired stockholder ratification. In a stockholder's derivative action for corporate funds disbursed both to the former management of the company involved and subsequently to the winning insurgents, the court, as a case of first impression, decided:

to draw no distinction between the "ins" and the successful "outs" . . . Once we assert that incumbent directors may employ corporate funds in policy contests to advocate their views to the stockholders even if the stockholders ultimately reject their views, it seems permissible to me that those who advocate a contrary policy and succeed in securing approval of the stockholders should be able to receive reimbursement, at least where there is approval by both the board of directors and a majority of the stockholders.<sup>11</sup>

The court, however, did find a distinction in the rationale for allowing disbursement to the successful "outs." The affirmative duty to keep shareholders apprised of corporate activities and issues in order to permit informed voting, which has justified management's use of the proxy machinery, is not mentioned.<sup>12</sup> Instead an analogy is found to the allowance of counsel fees to "the successful stockholder who brings a derivative action for the benefit of the corporation." Whether or not a management change will be beneficial is speculative, of course, unless the expression of the majority and a more fully informed electorate are considered benefits *per se*.

The court apparently did not consider ratification to be a prerequisite for reimbursement, but rather an added circumstance justifying it. Theoretically, shareholder approval is superfluous to confirm a benefit to the corporation, since the election itself has been so viewed, and approval only adds authority to acts already properly within the directors' discretion. As a practical matter, however, since successful opposition groups should normally encounter little difficulty in securing approval, the *Steinberg* case indicates the prudence of such action.

The limitations which had been established in earlier cases on the proxy expenses management may charge to the corpora-

<sup>10</sup> 90 F. Supp. 604 (S. D. N. Y. 1950).

<sup>11</sup> *Id.* at 608.

<sup>12</sup> Note 1 *supra*.

tion, were applied by the court to the successful insurgents. Expenditures must: (1) concern questions of corporation policy, not mere matters of personnel, and (2) be reasonable.<sup>13</sup> The court correctly acknowledged "that generally policy and personnel do not exist in separate departments," but perpetuated the first requirement by assuming that the proxy contest involved a policy issue since the plaintiffs failed to sustain the burden of proof to the contrary. Although this has never been a significant restriction,<sup>14</sup> the ambiguous requirement exists that contesting shareholders must clothe their proxy attacks on management in terms of corporate issues.

When the rule of reasonableness for solicitation expenditures was formulated, only nominal expenses were contemplated; but in the *Steinberg* case the insurgents' expenses exceeded \$25,000 and in at least one case an opposition group has spent over a million dollars.<sup>15</sup> There are no clear standards to determine if proxy expenditures are reasonable, either in character or amount, although two approaches have been used. They might roughly be called criteria of informing and campaigning. The former criterion restricts reasonableness to the actual cost of notifying the stockholders of the meeting and explaining the issues to them;<sup>16</sup> the second standard permits management also to defend its position and to attempt to persuade stockholders of the correctness of its reasoning. In the two states, Delaware and New York, where the law has developed, the courts have tended to adopt the more liberal, second view.<sup>17</sup> Examination of specific expenditures in order to ascertain the bounds of reasonableness is not illuminating except to reveal the courts' reluctance to dis-

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<sup>13</sup> *Ibid.* However, if the rationales for reimbursement differ, there might be logical differences in the nature of allowable expenditures. In an action to recover solicitation expenses from successful insurgent directors, one court stated that the attack made upon the reasonableness of specific expenditures would alone make the complaint sufficient, *Cullon v. Simmonds*, 285 App. Div. 1051, 139 N. Y. S. 2d 401 (2d Dept. 1955).

<sup>14</sup> In only two cases have courts refused to permit management reimbursement on the theory of absence of a policy issue; *Lawyers' Advertising Co. v. Consolidated Ry., Lighting & Refrigerating Co.*, 187 N. Y. 395, 80 N. E. 199 (1907), and *Rosenthal v. Edwards*, 119 N. Y. L. J. 1174, Co. 1, 4F (Sup. Ct., N. Y. County 1950).

<sup>15</sup> A New York Central R. R. shareholders' meeting voted to reimburse insurgents' proxy expenses of \$1,308,783. *New York Times*, May 27, 1955, p. 29.

<sup>16</sup> *Lawyers' Advertising Co.*, *supra* n. 14.

<sup>17</sup> *Aranow and Einhorn*, *op. cit. supra* n. 5, at 495.

allow expenditures unless clearly beyond the scope of "business judgment."<sup>18</sup>

In *Rosenfeld v. Fairchild Engine & Airplane Corporation*,<sup>19</sup> decided five years later, the New York Court of Appeals upheld the recoupment of proxy expenses by a successful opposition group, upon shareholder ratification, against a stockholder's derivative suit for restoration of over a quarter of a million dollars. The 4-3 division of the judges and the three opinions (3-1-3), however, accentuated the problems of the *Steinberg* case without reference to it.

Both majority and dissent discarded the accepted logic of corporate purpose for reimbursement, because the opposition group had "no duty . . . to set forth the facts, with corresponding obligation of the corporation to pay for such expenses." The benefit theory, set forth in the *Steinberg* case, was also rejected and the decision of the Appellate Division that ratification was crucial was upheld: "expenses should not be reimbursed by the corporation except upon approval by the stockholders."<sup>20</sup> But the dissent reasoned that the approval was ineffective because the vote, although 16-1, had not been unanimous as required by New York law since the expenditures were devoid of corporate purpose and *ultra vires*. The fourth concurring judge did not mention the problem of reimbursing the insurgents but based his decision upon the procedural requirement, stated by the three prevailing judges, that the plaintiff had failed to go forward with proof of excessive expenditure. The dissent, on the contrary, maintained that the inference of impropriety had shifted the duty upon the newly elected directors to justify their conduct.

The division of the judges creates confusion also as to the future course of New York law concerning the limits of reimbursement. The three prevailing judges adopted the accepted re-

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<sup>18</sup> The use of professional proxy solicitors, considered unreasonable by many legal writers [e.g., Friedmann, *Expenses of Corporate Proxy Contests*, 51 Col. L. Rev. 951 (1951), and Mintz, *Use of Corporate Funds for Proxies and Other Expenses in Fight over Corporate Management*, 8 N. Y. U. Intramural L. Rev. 90, 92 (1953)], and disapproved under the strict rule of *Lawyers' Advertising Co.*, supra n. 14, has become almost normal. "The contest was conducted by . . . employment of proxy solicitors and other devices not unusual in such campaigns," *Steinberg v. Adams*, supra n. 10. Use of proxy solicitors was held proper in *In re Zickl*, 73 N. Y. S. 2d 181 (Sup. Ct. 1947).

<sup>19</sup> 309 N. Y. 168, 128 N. E. 2d 291 (1955).

<sup>20</sup> 284 App. Div. 201, 132 N. Y. S. 2d 273 (1954).

quirements both of policy vs. personnel and of reasonableness. A majority, however, the one concurring and three dissenting judges, in varying degrees, apparently accepted neither, but preferred to revert to the strict criterion of the *Lawyers' Advertising Company* case.<sup>21</sup>

The *Steinberg* and *Fairchild* cases establish the significant new right of opposition shareholder groups to recoup their proxy expenses from the corporation. This right enhances their ability to participate "democratically," upon more equal terms with management, in their corporate responsibilities.

Nevertheless the right is a very restricted one. There is still a substantial difference between the insurgents' right to reimbursement if they win, and the manager's ability to defray expenses as they occur. And it is only in Delaware (*Steinberg*) and New York (*Fairchild*) that there is judicial authority for the right. It is yet to be pronounced in other states. The cases have also created extreme uncertainty regarding the necessity of ratification, the nature of allowable expenses, the burden of proving reasonableness, and the jurisdictional effect of the decided cases. Related is the further question whether the law of the state of incorporation or of the forum is to control such actions. In the *Steinberg* case the federal court expressly applied the law of the state of creation, but in the *Fairchild* case no mention is made by the New York court that a Maryland corporation was involved.<sup>22</sup>

Such limitation upon this new corporate right, and the courts' succinct and unsatisfactory reasons for its creation, impose the additional need to evaluate carefully the basis and desirability for its existence.

### Reimbursement of Unsuccessful Opposition

Neither the *Steinberg* nor the *Fairchild* cases mentioned the contestants' rights if they were unsuccessful or partially successful with cumulative voting. This issue has been considered in a single case, *Phillips v. United Corporation*.<sup>23</sup> There the court, lacking any precedents as authority, concluded: "It would be

<sup>21</sup> Notes 14 and 18 supra.

<sup>22</sup> Aranow and Einhorn, *op. cit. supra* n. 5, at 498.

<sup>23</sup> Civ. No. 40-497, S. D. N. Y., May 26, 1948, appeal dismissed, 171 F. 2d. 180 (2d. Cir. 1948), as quoted in Aranow and Einhorn, *op. cit. supra* n. 5, at 514.



difficult to find any reason for saddling plaintiff's proxy expenses on the corporation."

However, the logic of reimbursement seems applicable regardless of the ultimate outcome of a proxy contest. Unsuccessful battles for control may benefit the corporation in terms of the adoption of useful proposals, better informed shareholders, and a more sensitive management. Responsible proxy solicitation might also be furthered if reimbursement were not contingent upon a frantic, all-or-nothing gamble for control. But it is improbable that incumbent boards of directors will ever voluntarily choose to compensate unsuccessful insurgents for benefits received, and such reimbursement can be effected only through other means.

### **Proposals for Proxy Expenses Reimbursement**

The uncertainties of the *Steinberg* and *Fairchild* decisions indicate how difficult it is for state courts to solve the legal and economic questions of shareholder reimbursement on a case by case basis. Consequently numerous methods have been suggested to obtain a uniform and sensible means of reimbursement of proxy expenses, enforced by either state or national legislation. One feasible avenue of approach is the Securities Exchange Act, Section 14 on Proxies, although its limited coverage and the S. E. C.'s reluctance to deviate from the disclosure philosophy would be obstacles to its use as a means of implementing a reimbursement plan. Nevertheless, such factors as the language of the Act itself, apparent legislative intent,<sup>24</sup> and examples of affirmative rules already adopted,<sup>25</sup> indicate that its heretofore limited perspective is not mandatory.

Proposed plans for the reimbursement of shareholder proxy expenses include the following:

1. *Reimbursement Ceiling*—The stipulation of maximum amounts of reimbursement for different types of companies, applicable to "ins" as well as "outs," has been suggested.<sup>26</sup> A thorough study of the proxy requirements, by size of company,

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<sup>24</sup> Rule X-14 intends "power to control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which have frustrated the free control of the voting rights of stockholders," H. R. Rep. No. 1383, 73d Cong., 2d Sess. 14 (1934).

<sup>25</sup> E.g., Rule X-14A-4(b), requiring that stockholders be given opportunity to vote for or against each proposal on the proxy statement.

<sup>26</sup> Gilbert, *Dividends and Democracy* 166-168 (1956).

industry, and number and distribution of shares would be necessary, although the result would be the imposition of an inflexible, compromise figure. Reimbursement might better be based upon a procedure analogous to the rule in the Public Utility Holding Company Act which permits corporate proxy expense each year of \$1,000 plus the actual cost of solicitation;<sup>27</sup> only the basic cost of communicating would be allowed and contestants would be required to use their own funds for campaigning. Since the right of recoupment would not be contingent upon the group's success, some selective limitation would seem necessary in order to prevent drainage of the corporate assets by a multitude of different factions.

2. *Reimbursement Dependent upon Degree of Success*—One indication of the cogency and value of the insurgents' platform and claim to reimbursement is said to be the degree of success they achieve at the ballot box. Reimbursement might be permitted where a minority succeeded in electing a director under cumulative voting, or obtained a certain percentage of the vote.<sup>28</sup> A required percentage in the range of 10-15% has been suggested; but this would also require study, considering among other things the use of a variable standard for different situations and the results of voting on Proxy Rule X-14A-8 proposals.<sup>29</sup>

3. *Proportional Reimbursement*—The extent of reimbursement can be conditioned upon the degree of stockholder acceptance by the following formula, where x equals non-management expenses to be allowed but not to exceed actual expenses:

$$\frac{\text{management expenses allowed}}{\text{votes secured by management}} = \frac{x}{\text{votes secured by opposition}}$$

This method would provide a ceiling automatically equalized in relation to management activities, and at the same time screen contestants by the extent of their success.<sup>30</sup>

<sup>27</sup> 12(e) of the Public Utility Holding Co. Act of 1935, 49 Stat. 824, 15 U. S. C. § 79 1(e) (1952), Rule U-65, 17 C. F. R. § 250.65 (1949).

<sup>28</sup> Friedmann, *op. cit. supra* n. 18, at 962-64.

<sup>29</sup> Of the 229 X-14A-8 proposals voted on in the period from 1948-51, 85% received over 3% of the vote, 70% over 5% of the vote, and 40% over 8% of the vote. Emerson and Latham, SEC Proxy Proposal Rule: the Corporation Gadfly, 19 U. Chicago L. R. 807 (1952).

<sup>30</sup> Emerson and Latham, Proxy Contests: A Study in Shareholder Sovereignty, 41 Calif. L. R. 393, 436 (1953).

### Shareholder Use of the Management Proxy

It has been argued that the proxy statement does not belong to management exclusively, but ethically is the property of the corporation and the shareholders, who should have free access to it.<sup>31</sup> Authorizing security holders to use the management proxy form to nominate their directors is an alternative to reimbursement. The right would supplement the ability to solicit proxies independently but permit the initiation of nominees without the financial burden of a separate statement.

Restrictions would be necessary in order to prevent irresponsible nominations, although experience with Proxy Rule X-14A-8 has indicated an intelligent use.<sup>32</sup> Suggestions have been made for the forfeiture of a substantial deposit if a set percentage of the vote is not obtained,<sup>33</sup> and for the requirement that nominators hold a minimum block of stock; 5000 shares in one example.<sup>34</sup>

The proposal could be realized simply by an extension of Proxy Rule X-14A-8 to include the nomination of directors, which it now excludes.<sup>35</sup> With certain restrictions, shareholders would be permitted to place candidates for director on the management proxy with the personal information required by the S. E. C. and a supporting statement of a specified length. Such objections to the proposal as the limited authority of the Securities Exchange Act, the difficulty of procedural accommodation to varying state election statutes,<sup>36</sup> and the presence of devices to escape the proxy regulations,<sup>37</sup> do not compel abandonment of the idea.

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<sup>31</sup> Gilbert, *op. cit. supra*, n. 26.

<sup>32</sup> Emerson and Latcham, *op. cit. supra*, n. 29. Less than 2% of the management proxy statements filed with the SEC contained stockholder proposals. 16 SEC Ann. Rep. 42 (1951).

<sup>33</sup> Gilbert, *op. cit. supra*, n. 26.

<sup>34</sup> Latcham and Emerson, *Proxy Contest Expenses and Shareholder Democracy*, 4 W. Res. L. R. 5, 19 (1952).

<sup>35</sup> However Proxy Rule X-14A-8 has been used to propose a procedure for stockholder nomination of directors on the management proxy form. Illinois Central R. R. Co. proxy statement (1949). The objective of the proposal, as asserted by the supporting statement was "to provide an alternative to the one ticket type of election which has become characteristic of all too many large corporations." The proposal received between 8-10% of the vote cast. Emerson and Latcham, *op. cit. supra*, n. 29, at 819.

<sup>36</sup> Caplin, *Proxies, Annual Meetings and Corporate Democracy: The Lawyer's Rule*, 37 Va. L. R. 653, 689 (1951).

<sup>37</sup> Dean, *Non-Compliance with Proxy Regulations*, 24 Cornell L. Q. 483 (1939), and *Notes, Proxy Solicitation Costs and Corporate Control*, 61 Yale L. J. 229, 232 (1952).

The Commission evidenced willingness to broaden the disclosure philosophy when it circulated this idea of permitting stockholders' nominations on the management proxy form in connection with the 1942 revision of the proxy rules.<sup>38</sup> Such an amendment would go far toward effecting the objective of the Act, which in the words of a former S. E. C. Counsel is to make "the proxy device the closest practicable substitute for attendance at the meeting."<sup>39</sup>

### Conclusion

The ability of the shareholder to exercise the duties and rights of corporate democracy has been increased by the rather unsettled new right, announced in the *Steinberg* and *Fairchild* cases, that he can recoup proxy expenses from the corporation if successful.

The various Secretaries of State were requested by the writer, in his survey, to comment upon the desirability of the right of reimbursement, as well as its statutory coverage. The bulk of those answering declined to express an opinion, either because of frank ignorance of the problem or because the administrative function of their office precluded evaluation of policy questions. The right of reimbursement was endorsed by the five who offered personal and unofficial comments, although there was no uniformity in their suggested schemes of implementation.

One's attitude concerning the value of the right and the proposals to solidify it into statute or regulation depends upon underlying assumptions concerning the status of the shareholder. There are those who challenge the orthodox view that the shareholders, as owners of the capital and employers of management, should select the directors. The inefficiency of shareholder democracy is said to require a stewardship by the managers and faith by the owners.<sup>40</sup> Advocates of the right of reimbursement, on the other hand, demand that shareholders be given at least a periodic opportunity to confirm or disavow this faith. They insist that positive benefits accrue to the corporation

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<sup>38</sup> Hearings before the House Committee on Interstate and Foreign Commerce on H. R. 1821, and H. R. 2019, 78th Cong., 1st Sess. (1943). The idea was rejected as impracticable. Loss, *Securities Regulation*, 536 (1951).

<sup>39</sup> Loss, *Securities Regulation*, 525 (1951).

<sup>40</sup> See Martindell, *Scientific Appraisal of Management* (1950), and Dodd, *Modern Corporation, Private Property, and Recent Federal Legislation*, 54 *Harv. L. R.* 917, 921 (1941).

from an intercourse of ideas and personalities rather than from acquiescence in one-sided dictation.

Presupposing the validity of the traditional viewpoint, the latter, it is necessary to consider how the objective of responsible shareholder participation can best be served. The inapproximate criteria of informing and campaigning, advanced by the courts in order to gauge the reasonableness of proxy expenses, may aid in distinguishing how far the privilege of reimbursement should be extended. Modern proxy contests have assumed the proportions of full scale political campaigns. A right of full reimbursement contingent upon success stimulates such battles into becoming even greater extravaganzas. Proposals which create avenues of communication among the shareholders, by some limited formula of reimbursement or by an alternative such as the use of the management proxy statement, would seem better to reassimilate the shareholder as an effective contributor in corporation affairs.