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The Bizarre Law & Economics of *Business Roundtable v. SEC*

Grant M. Hayden^{*}
Matthew T. Bodie^{**}

INTRODUCTION

Corporate shareholders elect their boards of directors.¹ They do not, however, use anything like a conventional ballot. Instead, shareholders fill out a “proxy ballot” delivered to them by the incumbent board. This proxy ballot lists only the incumbent board’s chosen nominees, very often the same board members themselves. If a shareholder wants to run for director or propose another nominee for the board, she needs to provide all other shareholders with a separate proxy ballot.²

Throughout the last decade, the Securities & Exchange Commission (SEC) has been at work developing a rule for allowing shareholders to have access to the corporate proxy ballot.³ In 2010, the agency finally passed Rule 14a-11, which would have required corporations to put shareholder-nominated candidates on the company’s own proxy ballot (as long as certain conditions were met).⁴ The 2010 rule was the culmination of a process that included two previous incarnations, as well as legislation that specifically paved the way for the rule’s creation.⁵ Less than a year after its passage, however, the U.S. Court of Appeals for the D.C. Circuit struck down the law, holding that the SEC violated

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¹ See, e.g., DEL. CODE ANN. tit. 8, § 212(a); MODEL BUS. CORP. ACT § 7.21 (2007).

² See, e.g., DEL. CODE ANN. tit. 8, § 215; MODEL BUS. CORP. ACT § 7.22 (2007).

³ For a discussion of these proposals, see Part I *infra*.

⁴ Facilitating Shareholder Director Nominations, Securities Act Release No. 9136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384, 75 Fed. Reg. 56,668 (Sept. 16, 2010). The regulation was formerly codified as Rule 14a-11. See 17 C.F.R. § 240.14a-11 (2010), *vacated by* Business Roundtable v. S.E.C., 647 F.3d 1144, 1146 (D.C. Cir. 2011). The Commission recognized the vacation of the rule in Facilitating Shareholder Director Nominations, 76 Fed. Reg. 58100 (Sept. 20, 2011).

⁵ See Part I *infra*.

the Administrative Procedure Act by failing to consider the rule's costs and benefits adequately.⁶ According to the Court, the SEC's failure was so egregious that the Commission's decision to promulgate Rule 14a-11 was "arbitrary and capricious."⁷

Other commentators have noted that the D.C. Circuit's opinion rests on an extremely muscular version of judicial review—one that contravenes the traditional deference to administrative authority.⁸ Our concern, however, is with the court's misapplication of law and economics principles. The court's reasoning in *Business Roundtable* rests on flawed empirical and theoretical conclusions about proxy access and corporate governance. It ignores the benefits of facilitating shareholder democracy and focuses instead on costs that are routine for any functioning electoral system. As a result, its decision to strike down the regulation rests on a version of law and economics that contravenes the discipline's traditional principles and exacerbates agency costs.

Rule 14a-11 is open to debate on grounds of policy.⁹ But the *Business Roundtable* decision improperly sides with management by casting one side in the shareholder democracy debate as "arbitrary and capricious." It is, in fact, the court's opinion that uses economic and voting-rights principles in a capricious manner. In Part I, we provide a brief overview of Rule 14a-11 and the *Business Roundtable* decision. In Part II, we discuss the basic theory of voting rights and apply them to the shareholder franchise. In Part III, we discuss how the D.C. Circuit misconstrued the dynamics of shareholder voting and the role of Rule 14a-11 in the process. Finally, in part IV we discuss the larger problem exemplified by the *Business Roundtable* decision—namely, the growing preference amongst some law and economics

⁶ *Bus. Roundtable*, 647 F.3d, at 1146.

⁷ *Id.* at 1156.

⁸ See, e.g., Case Comment, *Administrative Law—Corporate Governance Regulation—D.C. Circuit Finds SEC Proxy Access Rule Arbitrary and Capricious for Inadequate Economic Analysis: Business Roundtable v. SEC*, 125 HARV. L. REV. 1088, 1093, 1095 (2012) (concluding that the court "applied an excessively exhausting standard that all but bars contested reforms"); Steven M. Davidoff, *Proxy Access in Limbo After Court Rules Against It*, N.Y. TIMES DEALBOOK, July 27, 2011, <http://dealbook.nytimes.com/2011/07/27/proxy-access-in-limbo-after-court-rules-against-it/> (noting that "the opinion appears to create an almost insurmountable barrier for the S.E.C. by requiring that it provide empirical support amounting to proof that its rules would be effective").

⁹ See, e.g., Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 EMORY L.J. 435, 439 (2012) (characterizing the rule as "a largely ineffective tool for shareholder nomination of directors"); Marcel Kahan & Edward B. Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347, 1432 (2011) (arguing that proxy access rules, in whatever form, are not "likely to be very important").

commentators for a Potemkin-Village version of shareholder democracy, one that undermines the very market principles that they purport to advance.

I. THE HISTORY OF PROXY ACCESS, FROM 1942 TO *BUSINESS ROUNDTABLE V. SEC*

The SEC's proxy access rule was not a lark; it was not a quick-draw policy change that came out of the darkness. Allowing shareholders direct access to the board's proxy ballot is, in many ways, an intuitive step. The proxy ballot is designed to look like an actual ballot—an instrument for casting one's vote in the election of directors. However, the proxy ballot is in fact simply an instruction to the board as to how one's shares should be voted at the annual meeting. The board decides the nominees to be placed on its own ballot and oversees its distribution. It is much more akin to a letter or request to the board, made on a form that the board has provided for that purpose, as to how the shareholder's shares should be voted at the meeting.¹⁰ It is not a ballot. The actual election is conducted at the shareholders' meeting, and the proxy ballots are used to give the board that shareholder's proxy votes. If the shareholder was personally appearing at the meeting, she could vote her shares in person and would have no need for a proxy. For those who are absent, the company's proxy ballot is a way for the incumbent board to facilitate votes—but on the board's own terms. Thus, in order to run against the incumbent board and/or the board's designated replacements, an “insurgent” candidate must provide her own proxy ballots for distribution. If the shareholder is voting with the board, she turns in the board's proxy; if voting for the opposition, either the shareholder must show up and vote directly or she must provide her proxy to the opposition's designee.

Because we are used to voting using a designated ballot, it is natural to confuse the proxy ballot with an actual one. This confusion is perhaps at the heart of the proxy access debates. Over time, the proxy ballot has been coopted by the government for various purposes. The proxy is generally accompanied by massive disclosures required by federal law; it includes votes over compensation packages and audit providers; and it provides shareholder access for independent referenda on questions relating

¹⁰ For examples of proxy ballots, see SEC, *Spotlight on Proxy Matters—Receiving Proxy Materials*, at: http://www.sec.gov/spotlight/proxymatters/proxy_materials.shtml (last visited April 3, 2012).

to a variety of potential subjects.¹¹ The ballots are generally sent (via mail or the web) to an accounting or proxy firm, which collects and counts the proxies, much like an independent election. Because of these accoutrements, the proxy ballot looks a lot more like a part of an independent electoral process rather than a request to the board to vote for the board's nominees as provided on a board form.

Less than a decade after the passage of the Securities Act of 1933, the SEC first considered proxy access for shareholders.¹² The proposal—debated internally—provided that “stockholders be permitted to use the management’s proxy statement to canvass stockholders generally for the election of their own nominees for directorships, as well as for the nominees of the management.”¹³ Shareholders would have only been permitted to add an additional nominee for each seat; thus, the company could stop adding nominees once they were twice the number of positions.¹⁴ The Commission did not formally act upon the idea.¹⁵

Proxy access came up for consideration again in 1977 and 1992. In 1977, the SEC deferred on access in favor of supporting the work of board nominating committees; the Commission intended for these committees to consider shareholder candidates as well.¹⁶ And in 1992, the Commission opted to expand Rule 14a-4¹⁷ to allow shareholders to include board nominees on their “short-slate” proxy ballots.¹⁸ This reform made it easier for

¹¹ For a list of the excluded subject areas for proxy proposals, see Rule 14a-8(i), 17 C.F.R. § 240.14a-18(j) (2011).

¹² SEC Securities Exchange Act of 1934 Release No. 3347 (Dec. 18, 1942) [hereinafter 1942 SEC Release].

¹³ See *Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 Before the House Comm. on Interstate and Foreign Commerce, 78th Cong., 1st Sess. 17-19 (1943)* (testimony of Chairman Ganson Purcell), cited in STAFF OF THE U.S. SECURITIES AND EXCHANGE COMMISSION REP., REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS 3 (2003), available at, <http://www.sec.gov/news/studies/proxyreport.pdf> [hereinafter 2003 SEC PROXY REPORT].

¹⁴ *Id.*

¹⁵ See 1942 SEC Release, *supra* note 12.

¹⁶ 2003 SEC PROXY REPORT, *supra* note 13, at 3. However, there were no formal requirements that the committees actually place dissident candidates on the ballot.

¹⁷ Rule 14a-4, 17 C.F.R. § 240.14a-4 (2011).

¹⁸ 2003 SEC PROXY REPORT, *supra* note 13, at 4. A “short slate” is a group of dissident directors that falls short of the number of open seats. *Id.* The change in Rule 14a-4 allowed shareholders to single out a certain number of board nominees for inclusion on the shareholders’ proxy ballots, even if the nominees did not want to be included. As an example, directors B1, B2, B3, B4, and B5 are running for reelection. If shareholders want to nominate S1 and S2 to run against B1 and B2, the shareholders can submit a proxy with S1, S2, B3, B4, and B5, in order to isolate B1 and B2, even if B3, B4, and B5 do not want to be on the shareholders’ proxies.

shareholders to seek minority representation on the board by targeting certain board nominees out of management's entire slate.¹⁹

Over the past decade, however, the SEC has pursued proxy access in earnest. The Commission proposed proxy access rules in 2003 as part of a broader suite of pro-shareholder reforms. Under the 2003 proposal, proxy access hinged on a "triggering event": either a vote on a special Rule 14a-8 proposal subjecting the company to proxy access, or a thirty-five percent or more "withhold" vote for one of the company's directors.²⁰ Once triggered, shareholder with at least five percent of the voting securities, held for at least two years, would be entitled to nominate between one and three director candidates.²¹ The proposal received numerous comments but, in the end, was never acted upon.²²

Three years later, the U.S. Court of Appeals for the Second Circuit held that a shareholder proposal under Rule 14a-8 to create proxy access for shareholder director candidates was improperly

¹⁹ *Id.*

²⁰ Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784, 60,789-90 (Oct. 23, 2003). The Rule 14a-8 proposal would have to have been submitted by a shareholder with at least one percent beneficial ownership for at least one year. *Id.* at 60,790.

²¹ *Id.* at 60,794-98. The formula for number of nominees was as follows:

As proposed, a company would be required to include one security holder nominee if the total number of members of the board of directors is eight or fewer, two security holder nominees if the number of members of the board of directors is greater than eight and less than 20 and three security holder nominees if the number of members of the board of directors is 20 or more. The proposal would have a separate standard for companies with classified or "staggered" boards of directors. Where a company has a director (or directors) currently serving on its board of directors who was elected as a security holder nominee, and the term of that director extends past the date of the meeting of security holders for which the company is soliciting proxies, the company would not be required to include on its proxy card more security holder nominees than could result in the total number of directors serving on the board that were elected as security holder nominees being greater than one if the total number of members of the board of directors is eight or fewer, two if the number of members of the board of directors is greater than eight and less than 20 and three if the number of members of the board of directors is 20 or more.

Id. at 60,797-98.

²² Kahan & Rock, *supra* note 9, at 1354.

excluded from a company's proxy materials.²³ The SEC had sided with the company, arguing that the proposal related to an election and was therefore excludable under Rule 14a-8(i)(8).²⁴ However, the court held that the exclusion only referred to proposals concerning a particular election, not those concerning procedural rules that apply to elections in general.²⁵ The *AFSCME* decision led to a period of some confusion in the proxy world, as the court had rejected the SEC's interpretation of its own rule. Thus, the SEC either would be stuck with the Second Circuit's decision or would have to change the rule.

The Commission, confronted with this legal fork in the road, essentially chose to explore both directions at once. In 2007 it released for comment two alternative proposals: a "shareholder access" proposal and a "status quo" proposal. Under the access proposal, the SEC would change Rule 14a-8(i)(8) to allow shareholders to submit proposals amending corporation bylaws that would give proxy access to shareholder nominees.²⁶ Only shareholders owning greater than 5% of a company's voting securities would be permitted to make proposals in the proxy materials affecting director nomination and election procedures.²⁷ The access proposal would allow such shareholders to offer whatever shareholder nomination procedures they desired in the proxy materials.²⁸ The only substantive limitations on such procedures would be those imposed by state law or the company's charter and bylaws.²⁹ The status quo proposal was a codification of the SEC's interpretation prior to the Second Circuit's overturning.³⁰ The effect of the status quo proposal would be to reverse the Second Circuit's decision in *AFSCME* and continue to

²³ *AFSCME v. AIG, Inc.*, 462 F.3d 121 (2d Cir. 2006).

²⁴ *See id.* at 123 (discussing previous version of Rule 14a-8(i)(8), which allowed companies to exclude a shareholder proposal under 14a-8 that "relates to an election").

²⁵ *Id.* at 130.

²⁶ Shareholder Proposals, Exchange Act Release No. 56,160, Investment Company Act Release No. 27913, 72 Fed. Reg. 43,466 (Aug. 3, 2007).

²⁷ *Id.* at 43,472. In addition, to be eligible shareholders could not have acquired or held their securities for the purpose of or with the effect of changing or influencing the control of the company and also had to meet the requirements of Schedule 13G. Any shareholder wishing to circumvent the rule would have to follow the SEC's other disclosure requirements for hostile takeovers and similar actions. *Id.*

²⁸ *Id.*

²⁹ *Id.* The actual form and substance of the proposed bylaw amendments by the shareholders would still be governed by the corporation or state law, and the SEC would only intervene regarding the procedures of proposing such a bylaw and the disclosure requirements.

³⁰ Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56,161, Investment Company Act Release No. 27914, 72 Fed. Reg. 43,488 (Aug. 3, 2007).

permit corporations to exclude from proxy materials shareholder proposals that would affect the director nomination and election procedures.³¹ Ultimately, the SEC adopted the status quo proposal in a divided 3-2 vote.³²

In 2009, the SEC released yet another iteration of proxy access. This version created a new rule—Rule 14a-11—that would provide for direct access to the ballot for shareholders.³³ The 2009 proposal significantly reduced the requirements for participation. Only 1% ownership was necessary for companies with over \$700 million in assets, sliding up to 3% for those with assets between \$75 million and \$700 million, and 5% for those under \$75 million.³⁴ The period for holding the securities was only one year, and a triggering event was no longer necessary.³⁵ Most significantly, the proposal would have made this access a mandatory part of the corporate structure, rather than merely allowing shareholders to implement it on their own.

The SEC received comments on the proposal up through 2010, when the Dodd-Frank Act specifically gave the Commission the authority to enact proxy access reforms.³⁶ Soon thereafter, the Commission adopted Rule 14a-11 on a 3-2 vote.³⁷ The final rule increased the ownership requirements to 3% but allowed shareholders to pool their holdings to reach that threshold. That 3% had to be held for three years prior to the nominations and up through the actual shareholder meeting. Shareholders were limited to nominating candidates for up to 25% of the seats on the board, and they could not intend a change in control.³⁸ In addition, the Commission amended Rule 14a-8 to allow shareholders to propose proxy nomination processes within their individual corporations.³⁹

³¹ *Id.* at 43,493.

³² Kahan & Rock, *supra* note 9, at 1355.

³³ Facilitating Shareholder Director Nominations, Securities Act Release No. 9,046, Exchange Act Release No. 60,089, Investment Company Act Release No. 28,765, 74 Fed. Reg. 29,024 (June 18, 2009).

³⁴ *Id.* at 29,035.

³⁵ *Id.* at 29,032, 29,035.

³⁶ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 971(b), 124 Stat. 1376, 1915 (2010) (codified as amended in scattered sections of 12 U.S.C.) [hereinafter Dodd-Frank Act] (“The Commission may issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer, under such terms and conditions as the Commission determines are in the interests of shareholders and for the protection of investors.”).

³⁷ Facilitating Shareholder Director Nominations, Securities Act Release No. 9,136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384, 75 Fed. Reg. 56,668 (Sept. 16, 2010).

³⁸ *Id.*

³⁹ 17 C.F.R. § 240.14a-8(i)(8) (2012). The revised Rule 14a-8 only excludes proposals that “(i) Would disqualify a nominee who is standing for election; (ii)

A little over a month after the rule was adopted, the Business Roundtable and the Chamber of Commerce filed a petition with the U.S. Court of Appeals for the D.C. Circuit seeking an injunction against the new rule.⁴⁰ The SEC stayed the rule pending judicial review.⁴¹ On July 22, 2011, the D.C. Circuit struck down the regulation under the Administrative Procedure Act⁴² for failing “adequately to consider the new rule’s effect upon efficiency, competition, and capital formation.”⁴³

The court based its ruling on three failures on the part of the Commission. First, the court found that the SEC failed to calculate the costs and the benefits of the new rule properly, specifically with respect to the incumbent board’s costs of opposing a shareholder nominee. According to the court, “the Commission failed to appreciate the intensity with which issuers would oppose nominees and arbitrarily dismissed the probability that directors would conclude their fiduciary duties required them to support their own nominees.”⁴⁴ The court also criticized the Commission’s “mixed empirical evidence” on the benefits of proxy access, and claimed that the agency had misapplied state law as an excuse for ignoring certain costs.⁴⁵ The second failure was the SEC’s neglect of the strategic uses of the rule for union and state pension fund shareholders. The court found “there was good reason to believe institutional investors with special interests will be able to use the rule” to advance their “self-interested objectives rather than the goal of maximizing shareholder value.”⁴⁶ Finally, as to the third failure, the court accused the Commission of emphasizing the infrequency of elections when assessing the costs, but not when

Would remove a director from office before his or her term expired; (iii) Questions the competence, business judgment, or character of one or more nominees or directors; (iv) Seeks to include a specific individual in the company’s proxy materials for election to the board of directors; or (v) Otherwise could affect the outcome of the upcoming election of directors.” *Id.*

⁴⁰ Petition for Review, *Bus. Roundtable v. SEC*, 2010 WL 3770710, at *2 (D.C. Cir.).

⁴¹ See Order Granting Stay In re Motion of Bus. Roundtable, Securities Act Release No. 9,149, Exchange Act Release No. 63,031, Investment Company Act Release No. 29,456 (Oct. 4, 2010), available at <http://www.sec.gov/rules/other/2010/33-9149.pdf>.

⁴² 5 U.S.C. § 551 *et seq.* (2006).

⁴³ *Business Roundtable*, 647 F.3d at 1146. See also *id.* at 1148 (“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. . . . We agree with the petitioners and hold the Commission acted arbitrarily and capriciously for having failed once again . . . adequately to assess the economic effects of a new rule.”).

⁴⁴ *Id.* at 1149.

⁴⁵ *Id.* at 1151.

⁴⁶ *Id.* at 1152.

assessing the benefits. According to the court, “the Commission's discussion of the estimated frequency of nominations under Rule 14a-11 is internally inconsistent and therefore arbitrary.”⁴⁷

The D.C. Circuit's decision striking down Rule 14a-11 surprised many observers, including opponents of the rule.⁴⁸ In fact, it seems fair to say that most academic commentators were quite critical of the opinion.⁴⁹ Much of the commentary focused on the level of review called for under the statute—“arbitrary and capricious”—when compared with the regulation's actual flaws as found by the court. This article, however, is not about the application of the Administrative Procedure Act to the SEC's proxy access regulation. Instead, it concerns the court's economic and voting-rights analysis supporting its decision to strike the regulation down. Before turning to that critique, we provide a brief overview of shareholder democracy, in theory and practice.

II. SHAREHOLDERS, DEMOCRACY, AND CORPORATE LAW

⁴⁷ *Id.* at 1153.

⁴⁸ Stephen M. Bainbridge, *Proxy Access Invalidated on APA Grounds*, PROFESSORBAINBRIDGE.COM, (July 22, 2011), <http://www.professorbainbridge.com/professorbainbridgecom/2011/07/proxy-access-invalidated-on-apa-grounds.html> (“Candidly, while I'm pleased, I'm also surprised. I had thought—and said publicly—that I thought this suit was a long shot.”).

⁴⁹ Case Comment, *supra* note 8 (saying that the opinion “made missteps similar to those for which [it] scolded the SEC,” and called it “troubling”); Davidoff, *supra* note 8 (noting that “the opinion appears to create an almost insurmountable barrier for the S.E.C. by requiring that it provide empirical support amounting to proof that its rules would be effective”); Brett McDonnell, *Dodd-Frank @1: An Overall Assessment*, THE CONGLOMERATE BLOG, (July 22, 2011), <http://www.theconglomerate.org/2011/07/dodd-frank-1-an-overall-assessment.html> (“This opinion is little more than the judges ignoring the proper judicial rule of deference to an agency involved in notice-and-comment rulemaking and asserting their own naked political preferences. Talk about judicial activism.”); Gordon Smith, Comment to Gordon Smith, *Business Roundtable v. SEC*, THE CONGLOMERATE BLOG, (July 22, 2011), <http://www.theconglomerate.org/2011/07/business-roundtable-v-sec.html#comment-261374058> (“I had told my students that I thought the lawsuit was not well-founded, so I was surprised by the opinion. I understand why people would oppose proxy access, but ‘arbitrary and capricious’? The process hardly seems to qualify for that characterization. . . . I am not enamored with the result here.”); David Zaring, *More on the DC Circuit's Proxy Access Decision*, THE CONGLOMERATE BLOG, (Aug. 4, 2011), <http://www.theconglomerate.org/2011/08/the-dc-circuits-proxy-access-decision-keeps-getting-attention-see-here-for-a-roundup-and-here-from-elliott-spitzer-seem.html> (saying that the court's analysis is “probably best characterized as fly-specking, and the kind of searching inquiry no agency could survive,” and that “the opinion isn't very good”).

All institutions, including business corporations, must make decisions. These decisions often involve judgments about the needs and desires of a wide variety of constituents. There are many ways to move from these individual preferences to institutional choices. And most of the institutions that comprise modern market economies—from governments to small businesses—employ a range of decisionmaking structures designed to take account of their constituents' preferences. They sometimes rely upon contracts, which are thought to ensure the preference satisfaction of everyone involved.⁵⁰ But once institutions reach a certain size and complexity, contracts alone can't do the job. At that point, the institutions resort to some sort of voting mechanism to translate individual preferences into institutional choices.

A. Governments

Democratic political institutions, of course, rely heavily on voting mechanisms to translate preferences into social choices; indeed, the ability of its constituents to cast a meaningful vote is what makes a government “democratic.” But when political institutions settle on voting as the preferred method of preference aggregation, they still have many decisions to make about how to structure the process. Those decisions often come to be embodied in a set of legal entitlements, or voting rights, which collectively sketch the contours of polity. Voting rights, though, are not unidimensional; instead, there are many distinct facets to the rights to vote, each of which is necessary to ensuring full democratic participation.⁵¹

The first aspect of the right involves access—the ability to cast a ballot.⁵² This is voting rights at its most fundamental. At

⁵⁰ See, e.g., Grant M. Hayden & Stephen E. Ellis, *The Cult of Efficiency in Corporate Law*, 5 VA. L. & BUS. REV. 239, 244-45 (2010).

⁵¹ Pam Karlan sets up a taxonomy of three aspects of the right to vote in Pamela S. Karlan, *Maps and Misreadings: The Role of Geographic Compactness in Racial Vote Dilution Litigation*, 24 HARV. C.R.-C.L. L. REV. 173, 176 (1989). See also Grant M. Hayden, *Resolving the Dilemma of Minority Representation*, 92 CALIF. L. REV. 1589, 1594-1602 (2004) [hereinafter *Dilemma*] (giving a brief account of the history of each aspect of the right). Other ways of parsing out the right to vote, see, e.g., Richard H. Pildes, *What Kind of Right is “The Right to Vote”?*, 93 VA. L. REV. 43 (2007); Pamela S. Karlan, *The Rights to Vote: Some Pessimism About Formalism*, 71 TEX. L. REV. 1705, 1709-20 (1993), are not inconsistent with this conception. Here, we take Karlan's taxonomy as a starting point and add the slating process into the mix.

⁵² For a relatively recent history of the right to vote, see ALEXANDER KEYSAR, *THE RIGHT TO VOTE: THE CONTESTED HISTORY OF DEMOCRACY IN THE UNITED STATES* (2000). For information about voting in the early years of the republic, see MARCHETTE G. CHUTE, *THE FIRST LIBERTY: A HISTORY OF THE RIGHT TO VOTE IN AMERICA, 1619-1850* (1969); CHILTON WILLIAMSON, *AMERICAN SUFFRAGE: FROM PROPERTY TO DEMOCRACY, 1760-1860* (1960). For

the beginning of the country's history, most states only extended the franchise to property-holding white men over the age of twenty-one.⁵³ That, of course, has changed, and many more groups have access to the ballot.⁵⁴ There are, however, some restrictions that remain: most jurisdictions restrict voting by felons or ex-felons,⁵⁵ noncitizens,⁵⁶ and nonresidents.⁵⁷ Minors and people with certain mental impairments are also not allowed to vote.⁵⁸ But, although we are far from universal suffrage, a greater proportion of the population can vote now than could at the country's founding.

In a sense, the question of "who" should have a right to vote is relatively straightforward. The debate is essentially over which groups should be considered members of the polity whose

information about voting rights in more recent years, with an emphasis on the quest for minority representation, see QUIET REVOLUTION IN THE SOUTH: THE IMPACT OF THE VOTING RIGHTS ACT, 1965-1990 (Chandler Davidson & Bernard Grofman eds. 1994); BERNARD GROFMAN, LISA HANDLEY & RICHARD NIEMI, MINORITY REPRESENTATION AND THE QUEST FOR VOTING EQUALITY (1992); STEVEN F. LAWSON, BLACK BALLOTS: VOTING RIGHTS IN THE SOUTH, 1944-1969 (1976); J. MORGAN KOUSSER, THE SHAPING OF SOUTHERN POLITICS: SUFFRAGE RESTRICTION AND THE ESTABLISHMENT OF THE ONE-PARTY SOUTH, 1880-1910 (1974).

⁵³ See KEYSSAR, *supra* note 52, at tbls. 1-3, for a list of the property and taxpaying requirements in the colonies and states between 1776 and 1855.

⁵⁴ African Americans and other racial minorities initially secured voting rights through a series of constitutional amendments. See U.S. CONST. amends. XIII (abolishing slavery), XIV (granting national citizenship and rights of due process and equal protection) & XV (prohibiting voting rights discrimination on the basis of race). For a discussion of passage of the Fifteenth Amendment, see WILLIAM GILLETTE, THE RIGHT TO VOTE: POLITICS AND THE PASSAGE OF THE FIFTEENTH AMENDMENT (1965); KEYSSAR, *supra* note 52, at 93-104. Those protections were lost as a result of Southern resistance and Northern indifference, see KEYSSAR, *supra* note 52, at 107, 111-16; KOUSSER, *supra* note 51,; GROFMAN ET AL., *supra* note 52, at 5-10; Hayden, *supra* note 51, at 1595, but largely restored with the passage of the Voting Rights Act of 1965. 42 U.S.C. §§ 1971-1973bb-1 (2000); see GROFMAN ET AL., *supra* note 52; LAWSON, *supra* note 51, at 10. On passage of the Voting Rights Act, see LAWSON, *supra* note 52, at 288-328; KEYSSAR, *supra* note 52, at 262-64. Women secured access to the polls in 1920 through the Nineteenth Amendment, U.S. CONST. amend. XIX, and eighteen- to twenty-year olds through the Twenty-Sixth Amendment. U.S. CONST. amend. XXVI.

⁵⁵ See Pamela S. Karlan, *Convictions and Doubts: Retribution, Representation, and the Debate over Felon Disenfranchisement*, 56 STAN. L. REV. 1147 (2004).

⁵⁶ See Jamin B. Raskin, *Legal Aliens, Local Citizens: The Historical, Constitutional, and Theoretical Meanings of Alien Suffrage*, 141 U. PA. L. REV. 1391, 1397-1418, 1460-67 (1993).

⁵⁷ See Glenn P. Smith, Note, *Interest Exceptions to One-Resident, One-Vote: Better Results from the Voting Rights Act?* 74 TEXAS L. REV. 1153, 1159 (1996) (explaining that, in the 1960s, residency became "the sole proxy for electoral interest. Residency – and, in most cases, residency alone – became the standard for granting suffrage to qualified potential voters.").

⁵⁸ See KEYSSAR, *supra* note 52, at 287-88.

preferences should be reflected in electoral outcomes. The issue becomes more complicated once we move from “who” votes to “how” they vote. It does so because the mechanics of most election procedures—things like registration requirements, voting methods, and vote counting—may themselves restrict the right to vote, but in more subtle ways that depend upon whether the procedures have disproportionate effect on some voter-relevant group.⁵⁹ For example, if a state requires voters to produce photographic identification in order to vote, and large numbers of, say, poor people lack such identification, then that may skew the outcome of the election.⁶⁰ In a sense, then, both who has a right to vote and how they vote, can affect access to the electoral system.

Mere access to the polls, though, guarantees very little, especially in a representative democracy.⁶¹ To begin with, votes may end up carrying different numerical weights.⁶² Sometimes, as in weighted voting systems, this is part of the design. The International Monetary Fund, for example, assigns different numbers of votes to each member country.⁶³ In other cases, votes are weighted differently as a result of deliberate indifference to underlying demographic changes. In the first half of the twentieth century, many states refused to redraw district lines in the face of

⁵⁹ See *Anderson v. Celebrezze*, 460 U.S. 780, 788 (1983) (noting that “[e]ach provision of these [state election codes], whether it governs the registration and qualifications of voters, the selection and eligibility of candidates, or the voting process itself, inevitably affects -- at least to some degree -- the individual's right to vote and his right to associate with others for political ends”); Christopher S. Elmendorf, *Structuring Judicial Review of Electoral Mechanics: Explanations and Opportunities*, 156 U. PA. L. REV. 313 (2007) (explaining the sliding scale of scrutiny applied to election codes).

⁶⁰ See, e.g., *Common Cause/Ga. v. Billups*, 406 F. Supp. 2d 1326, 1365-66 (N.D. Ga. 2005).

⁶¹ See Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 451 (2008) [hereinafter *False Promise*].

⁶² For background on this aspect of the right to vote, see STEPHEN ANSOLABEHRE & JAMES M. SNYDER, JR., *THE END OF INEQUALITY: ONE PERSON, ONE VOTE AND THE TRANSFORMATION OF AMERICAN POLITICS* (2008); ROBERT G. DIXON, JR., *DEMOCRATIC REPRESENTATION: REAPPORTIONMENT IN LAW AND POLITICS* (1968); REPRESENTATION AND MISREPRESENTATION: LEGISLATIVE REAPPORTIONMENT IN THEORY AND PRACTICE (Robert A. Goldwin ed., 1968); GORDON E. BAKER, *THE REAPPORTIONMENT REVOLUTION: REPRESENTATION, POLITICAL POWER, AND THE SUPREME COURT* (1966); ROBERT B. MCKAY, *REAPPORTIONMENT: THE LAW AND POLITICS OF EQUAL REPRESENTATION* (1965); Hayden, *Dilemma*, *supra* note 50; Grant M. Hayden, *The False Promise of One Person, One Vote*, 102 MICH. L. REV. 213 (2003) [hereinafter *One Person*].

⁶³ See Int'l Monetary Fund, *IMF Members' Quotas and Voting Power, and IMF Board of Governors*, (Mar. 15, 2012), at: <http://www.imf.org/external/np/sec/memdir/members.htm>.

tremendous demographic changes.⁶⁴ This had the effect of diluting the numerical voting power of those in more populous (largely urban) districts and concentrating it in the less populous (rural) districts,⁶⁵ a situation remedied by the Supreme Court's one person, one vote decisions in the 1960s.⁶⁶ The ability to cast a meaningful vote, though, can clearly be inhibited by either denying access to the polls or by numerically diluting one's vote.

Democratic political entities take many factors into consideration when making decisions about voting access and weight. Chief among these, though, is some assessment of a voter's interest in the political entity—what they have at stake in the outcome of the election.⁶⁷ Those with a strong interest in the outcome are prime candidates for the franchise; those with little or nothing riding on it are rarely extended voting rights. Given that voting mechanisms are primarily a method of aggregating individual preferences, it makes some sense to start with those who actually have strong feelings on the matters at issue.⁶⁸ They may also make better informed decisions and help ensure that the election outcome is viewed as legitimate.⁶⁹

Because political entities have no way of directly measuring the strength of one's preferences, they usually rely upon proxies for voter interest.⁷⁰ In the past, states relied upon property-holding and taxpaying requirements to ensure that those voting had a sufficient economic stake in the outcome of an election.⁷¹ While such restrictions now strike us as antiquated, and even discriminatory, we nonetheless still believe in the underlying assumption that voting should be tied to interest. We just think we have better proxies. Residency requirements, for example, allow us to target people living within the borders of a government whose power is, to a great degree, geographically circumscribed: those people within the borders are those with a greater stake in the outcome of elections.⁷² And this connection between voter access and voter interest has even been endorsed by the Supreme Court.⁷³

⁶⁴ See Hayden, *One Person*, *supra* note 62, at 219.

⁶⁵ See *id.*

⁶⁶ Reynolds v. Sims, 377 U.S. 533 (1964); Wesberry v. Sanders, 376 U.S. 1 (1964); Gray v. Sanders, 372 U.S. 368 (1963); Baker v. Carr, 369 U.S. 186 (1962).

⁶⁷ See Hayden & Bodie, *False Promise*, *supra* note 61, at 452-60.

⁶⁸ See *id.* at 453.

⁶⁹ See *id.*

⁷⁰ See *id.* at 460-62.

⁷¹ See *id.* at 454, 460.

⁷² See *id.* at 454-55, 460.

⁷³ See Holt Civic Club v. City of Tuscaloosa, 439 U.S. 60, 69 (1978); Kramer v. Union Free Sch. Dist., 395 U.S. 621, 632 & n.15 (1969); Hayden & Bodie, *False Promise*, *supra* note 61, at 455-56.

Political entities also attend to voter interest when assigning weights to votes. In weighted voting systems, the weight is often assigned in proportion to the voter's perceived stake in the enterprise. In the IMF, a member's voting power is largely determined by the resources it contributes to the fund.⁷⁴ Other types of voting systems follow suite, though sometimes in ways that aren't as obvious. Take, for example, the one person, one vote requirement. The U.S. Constitution requires that districting for the House of Representatives, both houses of state legislatures, and local governmental entities be done in a way that assigns equal numerical weight to votes.⁷⁵ The requirement may involve a positive judgment that all are equally interested in the outcome of an election; more likely, it reflects our inability to make such finely tuned assessments of the strength of people's preferences.⁷⁶ In any case, though, an exception to the one person, one vote requirements—special purpose districts—may help prove the relationship between voter interest and voting weight. The governing boards of special purpose districts are allowed to restrict the franchise to those most affected by its decisions and then further fine-tune voting weight with that interest.⁷⁷ Water boards, for example, are allowed to restrict voting to landowners and, further, weight the votes according to how much land each voter owns.⁷⁸ This one acre, one vote system is thought to more accurately tailor voter interest with voting weight.

The ability to cast an equally weighted vote, however, does not guarantee an equal opportunity to participate. There are a variety of other ways to keep like-minded voters from electing candidates of their choice. Some of these manipulate the ways in which votes are combined. At-large elections, anti-single-shot laws, and gerrymanders have all been used to dilute the voting power of certain groups.⁷⁹ Gerrymandering district boundaries, for example, can take groups that could constitute an effective majority in one district and split them into two districts so they're a majority in neither.⁸⁰ The legal status of attempts to dilute a

⁷⁴ See Int'l Monetary Fund, *supra* note 63.

⁷⁵ See *Wesberry v. Sanders*, 376 U.S. 1 (1964) (House of Representatives); *Reynolds v. Sims*, 377 U.S. 533 (1964) (state legislatures); *Avery v. Midland County*, 390 U.S. 474, 479-81 (1968) (local governments).

⁷⁶ See Hayden, *One Person*, *supra* note 62, at 251-52.

⁷⁷ See *id.* at 252-55.

⁷⁸ See, e.g., *Salyer Land Co. v. Tulare Lake Basin Water Storage Dist.*, 410 U.S. 719 (1973) (water district not subject to usual one person, one vote requirements); *Ball v. James*, 451 U.S. 355 (1981) (same).

⁷⁹ See BERNARD GROFMAN, LISA HANDLEY & RICHARD NIEMI, *MINORITY REPRESENTATION AND THE QUEST FOR VOTING EQUALITY* 23-24 (1992).

⁸⁰ See Frank R. Parker, *Racial Gerrymandering and Legislative Reapportionment*, in *MINORITY VOTE DILUTION* 85, 86-99 (Chandler Davidson ed., 1984). These strategies of "cracking" and "packing" voters are discussed in

group's voting power depends upon the type of group being targeted. Racial minorities are afforded greater legal protection than, say, members of a political party.⁸¹

The other way to keep groups from electing their preferred candidates is to interfere with the slating process. This may be done from the top down, by, say, prohibiting certain candidates from running for or holding office. In the aftermath of the Civil War, the federal government forced states to allow blacks to vote; the state of Georgia immediately responded by passing a law that prohibited blacks from holding office.⁸² One may also interfere with group voting power from the bottom up, by limiting group members' access to earlier stages of the slating process. In the first half of the twentieth century, southern states used the white primary as a means of keeping black voters out of the primary elections, eliminating their preferred candidates at that stage, and then leaving them to choose between unpalatable alternatives in the general election.⁸³ The group in control of the slating process can effectively control electoral outcomes.⁸⁴

In the United States, the slating processes for federal, state, and local offices, as well as those for state initiatives, are largely controlled by the states. And, in addition to the historical attempts to control black voting rights, states have used a variety of techniques to limit ballot access. Most states have relied upon filing fees and signature requirements, or some combination of the two, to qualify for placement on the ballot.⁸⁵ The filing fees typically vary by office, are sometimes based upon some percentage of the yearly salary for that office, and may sometimes be waived, in whole or in part, with the submission of a certain number of signatures.⁸⁶ The signature requirements may be stated either in absolute terms or calculated as a percentage of the voter

several Supreme Court opinions as well. *See, e.g.,* Thornburg v. Gingles, 478 U.S. 30, 46 n.11 (1986).

⁸¹ Compare *Miller v. Johnson*, 515 U.S. 900, 916 (1995) (applying strict scrutiny when race is the predominant factor in districting) with *Vieth v. Jubelirer*, 541 U.S. 267 (2004) (refusing to adjudicate a political gerrymandering claim).

⁸² See KEYSSAR, *supra* note 52, at 86.

⁸³ See generally DARLENE CLARK HINE, *BLACK VICTORY: THE RISE AND FALL OF THE WHITE PRIMARY IN TEXAS* (2003).

⁸⁴ This is also true for the less obvious reason that a group with agenda control can take advantage of potential voting cycles and manipulate an agenda in a way that favors its desired outcome. See Grant M. Hayden, *Some Implications of Arrow's Theorem for Voting Rights*, 47 STAN. L. REV. 295, 312-313 (1995).

⁸⁵ See Mark R. Brown, *Popularizing Ballot Access: The Front Door to Election Reform*, 58 OHIO ST. L.J. 1281, 1284-85 (1997).

⁸⁶ See, e.g., *Signature Requirements and Deadlines for 2012 State Legislative Elections*, BALLOT*PEDIA (March 15, 2012), http://ballotpedia.org/wiki/index.php/Signature_requirements_and_deadlines_for_2012_state_legislative_elections.

turnout in some recent election, usually a gubernatorial election.⁸⁷ The barriers to entry are often designed in a way to be particularly onerous for minority party and independent candidates.⁸⁸

Ballot access restrictions are typically justified on two main grounds. First by limiting the number of candidates or alternatives on the ballot, the restrictions are thought to prevent voter confusion.⁸⁹ Second, ballot access laws are believed to promote electoral stability by keeping frivolous candidates off the ballot or, more to the point, preserving the two-party system.⁹⁰ Other goals include more tangential benefits, such as the government's interest in the revenue raised through filing fees.⁹¹

Restricting ballot access, however, comes at a real democratic cost. As discussed above, elections are first and foremost about preference aggregation. People's preferences about all sorts of things—from food to books to political candidates—range widely, and any respectable system of preference aggregation needs to account for that variation. (For that very reason, one of the principles of democratic fairness in Arrow's Theorem is universal admissibility, which demands that a social choice mechanism needs to be able to work with any possible preference profile.)⁹² People's preferences won't be meaningfully reflected in electoral outcomes if too many options are taken off the table before voting even begins. To put it in more market-oriented terms—ballot access laws are government regulations that stifle election competition.

For these reasons, the Supreme Court has analyzed ballot access as an integral component of the right to vote. In order to be more than a procedural formality, the right to vote effectively must be understood as the right to vote for a candidate of one's own choosing.⁹³ This initially led the Court to view all ballot access laws with great suspicion, subjecting them to strict scrutiny, which required the state to justify any restriction as a necessary means to a compelling governmental end.⁹⁴ The Court devised and applied that standard in the 1968 decision *Williams v. Rhodes*, striking down an Ohio requirement that new party candidates had to submit over 400,000 signatures by February of an election year.⁹⁵

⁸⁷ See *id.*

⁸⁸ See Oliver Hall, *Death by a Thousand Signatures: The Rise of Restrictive Ballot Access Laws and the Decline of Electoral Competition in the United States*, 29 SEATTLE U. L. REV. 407, 421-24 (2005).

⁸⁹ See *id.* at 420-21.

⁹⁰ See *id.* at 420-24.

⁹¹ See Brown, *supra* note 85, at 1307.

⁹² See Hayden, *supra* note 84, at 298.

⁹³ See Hall, *supra* note 88, at 425.

⁹⁴ See *Williams v. Rhodes*, 393 U.S. 23, 31 (1968).

⁹⁵ See *id.* at 28-30; see also Hall, *supra* note 88, at 424-48.

Since *Williams*, however, the Court has been less critical of ballot access laws because, upon reflection, it turns out that the mechanics of most state election procedures—including ballot access and other things such as registration requirements, voting methods, and vote counting—may, in some sense, restrict the right to vote. And subjecting every one of these state requirements to strict scrutiny seemed excessive. The Supreme Court avoided such a result by fashioning a new method of analyzing constitutional challenges to the mechanics of registration and voting. In *Burdick v. Takushi*, the Court established a sliding scale where the degree of judicial scrutiny given to a state requirement depends upon the “character and magnitude” of its burden on voting rights.⁹⁶ Where the voting rights are subject to “severe” restrictions, something akin to ordinary strict scrutiny is applied where the regulation must be “narrowly drawn to advance a state interest of compelling importance.”⁹⁷ But in cases where the regulation imposes only “reasonable, nondiscriminatory restrictions” upon voting rights, “the State’s important regulatory interest are generally sufficient to justify” the restrictions.⁹⁸ Thus, the unidimensional application of strict scrutiny is moderated in recognition of the fact that all election regulations have some effect on the right to vote.

Ballot access laws, then, are supposed to strike an appropriate balance between maintaining electoral stability and preserving meaningful choice. In effect, however, the move away from strict scrutiny has given states quite a bit of leeway when it comes to restricting access to the ballot. Minor party and independent candidates oftentimes have a difficult time making it onto the ballots, diminishing the range of options available to voters, and leading some scholars to argue that ballot access laws are the most anti-competitive feature of the American political system.⁹⁹

* * *

Democratic political entities, then, devise voting systems designed to produce group decisions that accurately reflect the underlying individual preferences. They begin by indentifying people with an interest in the polity and ensuring that they have equal access to the voting system. Those votes are weighted equally unless there’s some strong reason to suspect that people’s levels of interest are unequal in a way that can be accurately measured (as with special purpose districts). Once these individual voting rights are secure, care must be taken to ensure that groups

⁹⁶ 504 U.S. 428, 434 (1992).

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ See Hall, *supra* note 88, at 413-16.

of like-minded individuals have an equal opportunity to elect candidates of their choice, something that can be frustrated in a variety of ways in either the slating process or the vote aggregation process. In the end, a democratic political system is designed to translate individual preferences into group choices without skewing the result in any particular direction.

B. Corporations

While business corporations are very different from political entities, they too confront the issue of translating individual preferences into group choices.¹⁰⁰ When we think of a corporation, we generally picture a collection of people and assets with some common commercial goal. In a legal sense, though, a corporation is a fiction—an entity created by the government with no independent existence. Thus, perhaps it's more useful to conceive of a corporation as a legal structure designed to allocate rights and duties among a group of people devoted to some shared enterprise.¹⁰¹ The group itself is a rather diverse set of constituents, and may be said to include the many types of people with an interest in the enterprise, including directors, officers, shareholders, employees, bondholders, suppliers, and even customers.

While there are a number of features considered essential to the legal structure of a corporation,¹⁰² the keys to its decisionmaking structure (and thus this paper) are shared ownership by investors and delegated management.¹⁰³ The three players within this governance structure are the shareholders, the board of directors, and the officers.¹⁰⁴ The shareholders, sometimes called the “owners” of the firm, have the right to receive residual profits as well as the right to elect the board of

¹⁰⁰ Hayden & Bodie, *False Promise*, *supra* note 61, at 460.

¹⁰¹ Corporations are not, of course, the only form of business organization—there are sole proprietorships, partnerships, trusts, and an assortment of variations of them. Corporations, though, are generally viewed as the most complex business entity, and the one that currently dominates the economic activity in the United States.

¹⁰² Scholars have isolated five factors which are considered essential to the corporate form: (1) full legal personality, including the ability to bind the firm to contracts; (2) limited liability for owners and managers; (3) shared ownership by investors of capital; (4) delegated management under a board structure; and (5) transferable shares. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439-440 (2001). Cf. ROBERT C. CLARK, *CORPORATE LAW 2* (1986) (listing four characteristics of the corporation: (1) limited liability, (2) free transferability of investor interests, (3) legal personality, and (4) centralized management).

¹⁰³ Hansmann & Kraakman, *supra* note 102, at 440.

¹⁰⁴ CLARK, *supra* note 102, at 93.

directors.¹⁰⁵ The directors are, in turn, the locus of authority within the corporation; they are the representatives of the firm when human counterparts to the fictional form are required.¹⁰⁶ The board of directors, though, does not generally run the business; directors usually delegate this power to the officers of the corporation. These officers in turn select the remaining employees. The structure is hierarchical, in that shareholders can vote out directors, directors can fire the officers, and officers can fire the remaining employees.¹⁰⁷

When looking at this structure in the context of political institutions, we are immediately struck by the fact that it is only shareholders who are having their preferences aggregated. The corporation encompasses the daily activities of a variety of different players: directors, officers, executives, management, and employees. Moreover, there are a variety of outside “stakeholders” who have interests in the activities of the corporation, akin to shareholders: bondholders, suppliers, customers, even the community at large. However, when it comes to aggregating the preferences of the polity, in order to determine the leadership of the corporation, only shareholders are invited to participate.

This structure looks like it runs against the basic prescription in politics that all those with an interest in the enterprise should be accorded voting rights. But the way corporations are structured is thought to aggregate the preferences of all of all constituents in the most efficient manner. Most corporate constituents, inside and outside the corporation, have their preferences captured through contracts that fix their entitlements.¹⁰⁸ Employees, for example, receive a certain wage for their labor; consumers buy the company’s products at a certain price. These contracts are thought to be the most straightforward way to capture the preferences since all parties consenting to a contract prefer the state of affairs under the contract.¹⁰⁹ Thus, each contract is posited to be a Pareto improvement.¹¹⁰ Shareholders have their entitlements fixed by contract too, but among their entitlements is the right to elect the board of directors (and, ultimately, control the firm).¹¹¹

¹⁰⁵ This designation is something of a misnomer. See text accompanying notes 116 & 117 *supra*.

¹⁰⁶ CLARK, *supra* note 102, at 21.

¹⁰⁷ Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 555-58 (2003) (discussing the hierarchical nature of corporate structure).

¹⁰⁸ *Id.* at 553.

¹⁰⁹ *Id.* at 583.

¹¹⁰ *Id.* at 583-84.

¹¹¹ *Id.* at 548.

The primary justification for limiting voting rights to shareholders is the theory of shareholder primacy.¹¹² Shareholder primacy is the theoretical driver not only for the vote, but also for such key concepts as the fiduciary duties of care and loyalty.¹¹³ Shareholder primacy essentially means that corporations exist to serve the interests of shareholders.¹¹⁴ Put more specifically, the theory mandates that the corporation be run with the goal of maximizing shareholder wealth.

Shareholder primacy could simply be a democratic legitimacy argument: the corporation has to keep shareholder interests at the forefront, because shareholders are the voting polity. But this leaves a critical question unanswered: who made the shareholders the voting polity? The choice of this group as the voting “citizens” of the polity is what needs justifying.¹¹⁵ A variant of this justification is that shareholders are the corporation’s “owners” and thus were entitled to the ownership rights of profits and control.¹¹⁶ However, the ownership justification is also doomed by its circularity: who made the shareholders the “owners”?¹¹⁷ Labeling shareholders “owners” is no more of a justification for the vote than is labeling them “voters”.

Frank Easterbrook and Daniel Fischel provided a justification for shareholder primacy beyond simple labels. In looking to ground shareholder primacy in economic theory, they looked to the traditional economic utility rationale of creating the highest level of efficiency or overall social utility.¹¹⁸ Shareholder primacy theory argues that maximizing shareholder wealth will generate the highest amount of surplus and thus will result in the greatest overall social utility.¹¹⁹ Instead of being the “owners” of the corporation, shareholders were one group of many whose contracts with one another jointly created the fictional corporate “entity.”¹²⁰ However, shareholders were the sole “residual claimants:” that is, their returns were not payable until the other contractual

¹¹² *See id.* at 569-71.

¹¹³ FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 90-93 (1996).

¹¹⁴ *See* D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 277 (1998) (“The structure of corporate law ensures that corporations generally operate in the interests of shareholders.”).

¹¹⁵ *Id.* at 278-79.

¹¹⁶ The classic example of this perspective is Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG. 32-33, 122-26, (Sept. 13, 1970), .

¹¹⁷ *See, e.g.*, Lynn Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1190-92 (2002) (“[T]he claim that shareholders own the public corporation simply is empirically incorrect.”).

¹¹⁸ EASTERBROOK & FISCHEL, *supra* note 113, at 35-39.

¹¹⁹ *Id.*

¹²⁰ *Id.* at 36.

participants—creditors, employees, customers, suppliers—had been fully satisfied.¹²¹ Because shareholders are not paid until these set contractual payments have been made, all other claimants received their contractual entitlements, and the shareholders benefited from the maximization of the residual.

Control of corporate decisionmaking is, ultimately, concentrated in the hands of the shareholders in order to maximize the preference satisfaction of all involved. Shareholders, as the residual claimants, are assigned what is left after all fixed claims on corporate proceeds have been paid.¹²² Managers and directors are assigned, by contract or statute, a fiduciary duty to shareholders in order to make the residual attractive.¹²³ And other parties can be offered enough to keep them involved in the corporate enterprise.¹²⁴ Total proceeds are supposed to be higher if the residual claims are assigned to one group.¹²⁵ Shareholders get the nod over other stakeholders in lieu of contractual claims because that is the best way to induce them to put their money at risk while also relinquishing any real control over how it is used.¹²⁶ Again, the result is a combination of managerial control (as expressed by the business judgment rule) and shareholder interest (expressed by charging the managers with maximizing shareholder wealth) that is supposed to be a Pareto improvement over both direct shareholder control and a system that tries to look out for all stakeholder interests.¹²⁷

This is why the “one share, one vote” rule is a “logical consequence” of the theory of shareholder primacy.¹²⁸ The “one share, one vote” rule requires that each share of stock have equal voting weight with all other shares. In this way, the voting interest is equal to the interest in the residual. Shares with disproportionate voting power create skewed incentives. As Easterbrook and Fischel argue, “Those with disproportionate voting power will not receive shares of the residual gains or loss from new endeavors and

¹²¹ *Id.* at 36-37. This perspective assumes that all other claimants have rigidly-set contractual entitlements, such that paying them more would be akin to a gift.

¹²² *Id.* at 67-70.

¹²³ *Id.* at 90-93.

¹²⁴ *Id.* at 22-25.

¹²⁵ *Id.* at 35-39.

¹²⁶ *Id.* at 67-70.

¹²⁷ *Id.* at 35-39. See also Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 306-07 (1976) (arguing for shareholder primacy); Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 Wm. & Mary L. Rev. 1629, 1671 (2002) (defending the exclusive shareholder franchise).

¹²⁸ EASTERBROOK & FISCHEL, *supra* note 113, at 73 (“Votes follow the residual cost of the firm, and unless each element of the residual interest carries an equal voting right, there will be needless agency cost of management.”)

arrangements commensurate with their control; as a result, they will not make optimal decisions.”¹²⁹ As a result, those with control will have the incentive to seek disproportionate gains that do not directly inure to the owners of the residual.¹³⁰ The residual will no longer be maximized, discouraging equity investment and leading to a decline in societal efficiency.

Thus, the theory of shareholder primacy rests on the notion that shareholders will improve social welfare by focusing on increasing the corporation’s residual profits. Shareholder primacy is enforced through shareholder voting and by the market for corporate control which uses the shareholder vote to effectuate changes in management. Essential to the theory is the notion of shareholder homogeneity: namely, that shareholders all have a common, homogeneous interest in increasing residual profits.

Over the last several years, however, it has become clear that shareholders are not, in fact, the homogeneous wealth maximizers they were once thought to be. Instead, their interests diverge along a number of dimensions.¹³¹ Shaun Martin and Frank Partnoy have recently focused attention upon the problems caused by equity derivatives, which carve up various shareholder rights into discrete financial securities.¹³² But there are many other ways in which shareholders fail to share common interests. For example, some shareholders may be in a control group, and others may not.¹³³ Employee and pension-holding shareholders have different interests from non-employee shareholders.¹³⁴ Traditional shareholders may have different time horizons for wealth maximization that cannot be costlessly equalized through existing financial instruments.¹³⁵ And even when shareholder interests line up and they agree on a definition of wealth maximization, they

¹²⁹*Id.* See also Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1945-46 (1996) (“The case for the one share, one vote rule turns primarily on its ability to match economic incentives with voting power and to preserve the market for corporate control as a check on bad management.”).

¹³⁰ See Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 851 (2006). (discussing concerns that controlling shareholders without a commensurate economic stake in the corporation are more likely to “tunnel” away a disproportionate share of firm value).

¹³¹ See Hayden & Bodie, *False Promise*, *supra* note 61, at 477-99 (cataloguing the ways in which shareholder interests diverge); Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. REV. 561, 577-93 (2006) (same).

¹³² Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 778-81; see also Hu & Black, *supra* note 130, at 815..

¹³³ See Hayden & Bodie, *False Promise*, *supra* note 61, at 477-80.

¹³⁴ See *id.* at 486-88.

¹³⁵ See *id.* at 492-94.

may differ as to the best way to achieve that goal.¹³⁶ Ultimately, the notion that shareholders have homogeneous preferences is a simplifying assumption that is increasingly under strain.¹³⁷

The lack of shareholder homogeneity carries two consequences. First, the principal arguments for exclusive shareholder voting are, to put it charitably, less persuasive than once believed.¹³⁸ Second, the lack of homogeneity puts pressure on the way in which the voting mechanism is structured. Of course, all social choice procedures are intended to work with diverse preferences. The entire point of most voting systems or other is to take a set of individual preference profiles and aggregate them into a group choice (indeed, if preferences were completely homogeneous, we could just poll one member of the electorate and skip the rest of the process). We do, however, need to ensure that the voting structure doesn't skew in any particular direction.

In the relatively simplified world of corporate elections, taking care of such a problem is not that difficult. We should not, for example, be that concerned about skewing a result toward a minority interest—simple majority votes on the largely binary sets of alternatives will take care of that. More worrisome is that a tyrannical majority, temporary or otherwise, will exploit a minority interest. Most political democracies attempt to blunt the effects of what the founders called “faction” by making a system of government less responsive to the electorate and providing substantive protections to minorities.¹³⁹ The same approach is taken in corporate law, where there are many layers between shareholders and most corporate decisionmaking and various protections for minority shareholders.¹⁴⁰

One thing that's typically off the table is limiting the voting rights of a particular group of voters because of the content of their

¹³⁶ See Grant M. Hayden & Matthew T. Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise*, 62 VAND. L. REV. 1217, 1230-32 (2009).

¹³⁷ See Martin & Partnoy, *supra* note 132, at 778 (“It is simply not true that the ‘preferences of [shareholders] are likely to be similar if not identical.’” (quoting EASTERBROOK & FISCHER, *supra* note 113, at 405)). See also Hayden & Bodie, *False Promise*, *supra* note 61, at 477-99; see also Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021, 1052 (1996) (“For fictional shareholders, whatever else the people behind them may want, all want to maximize the value of their shares.”).

¹³⁸ Hayden & Bodie, *False Promise*, *supra* note 61, at 499-504.

¹³⁹ In the United States, this meant, among other things, dividing the government into three branches with checks on each other, dividing the federal legislature into two chambers, and making one of those chambers (the Senate) less responsive to the people. The substantive protections are embodied in the Bill of Rights and some of the subsequent amendments to the Constitution.

¹⁴⁰ For a discussion of protections for corporate minority shareholders, see Anupam Chander, *Minorities, Shareholder and Otherwise*, 113 YALE L.J. 119 (2003).

preferences. It is a fundamental principal of democratic fairness that people should not be ineligible to vote because of their opinions.¹⁴¹ This is also consistent with the demands of standard economics that you take preferences as they come.¹⁴² People's preferences are supposed to determine market outcomes and be reflected in institutional decisionmaking rather than the other way around.¹⁴³ The function of a voting procedure, for political and corporate entities, is to aggregate those preferences.

III. *BUSINESS ROUNDTABLE* AND THE LAW AND ECONOMICS OF SHAREHOLDER VOTING

Critics have assailed the *Business Roundtable* decision as a “troubling” effort aimed at “asserting [the judges’] own naked political preferences.”¹⁴⁴ The court imposed a far tougher standard on the Commission than the APA’s “arbitrary and capricious” standard would seemingly require.¹⁴⁵ However, at the root of the court’s analysis is a skewed view of the economics underlying the proposed Rule 14a-11. It is the court’s law and economic analysis, rather than its application of administrative law, that we intend to explore in this article. The *Business Roundtable* opinion demonstrates both bad empirical analysis of the underlying costs and benefits, as well as bad theory about the effect of the rule on the company and shareholder behavior. These two failings are discussed in more depth below.

A. *Bad Empirics*

According to the D.C. Circuit, the SEC had an obligation to “determine the likely economic consequences of Rule 14a-11 and to connect those consequences to efficiency, competition, and capital formation.”¹⁴⁶ One of the court’s primary criticisms of the SEC’s rulemaking on Rule 14a-11 was its supposed failure to

¹⁴¹ U.S. CONST. amends. I, XIV, XV, and XIX.

¹⁴² See Stephen E. Ellis, *Market Hegemony and Economic Theory*, 38 PHIL. SOC. SCI. 513 (2008).

¹⁴³ See *id.*

¹⁴⁴ Case Comment, *supra* note 8, at 1095 (saying that the opinion “made missteps similar to those for which [it] scolded the SEC,” and called it “troubling”); McDonnell, *supra* note 8 (“This opinion is little more than the judges ignoring the proper judicial rule of deference to an agency involved in notice-and-comment rulemaking and asserting their own naked political preferences. Talk about judicial activism.”).

¹⁴⁵ See, e.g., Davidoff, *supra* note 8 (noting that “the opinion appears to create an almost insurmountable barrier for the S.E.C. by requiring that it provide empirical support amounting to proof that its rules would be effective”).

¹⁴⁶ *Bus. Roundtable*, 647 F.3d at 1149.

demonstrate that the rule was justified by empirical evidence. According to the court, the Commission had “not sufficiently supported its conclusion” that the new rule would improve company performance and shareholder value “[i]n view of the admittedly (and at best) ‘mixed’ empirical evidence.”¹⁴⁷ Commentators have pointed out that this view of the evidence flips the standard of review on its head, by requiring an agency to demonstrate conclusively that its regulation will provide more benefits than costs.¹⁴⁸ But on a more fundamental level, the court misperceives its ability to judge the regulation’s support in the empirical literature.

According to the court’s analysis, the SEC “relied upon insufficient empirical data when it concluded that Rule 14a-11 will improve board performance and increase shareholder value by facilitating the election of dissident shareholder nominees.”¹⁴⁹ However, the court’s own analysis of the empirical data is extremely cursory, particularly in contrast to that of the Commission. In its Final Rule, the SEC spends significant time reviewing a variety of empirical studies that have been conducted on the issue.¹⁵⁰ Indeed, the court itself notes that the Commission “acknowledged the numerous studies submitted by commenters that reached the opposite result.”¹⁵¹ However, the court itself cites to only one of those studies. It then attacks two of the studies that the Commission did rely on. It again cited to the Commission’s own acknowledgment, this time that one of the supporting studies has long-term findings that are “difficult to interpret.”¹⁵² Other than that, the court simply called the two studies “unpersuasive” and the overall evidence “(at best) mixed” and concluded that the SEC had “not sufficiently supported its conclusion.”¹⁵³

The court’s cursory analysis of the empirical debate fails on many levels. First, it is completely unpersuasive in its attempt to show that the empirical literature stacked up in opposition to the rule. The court’s only citation to this opposing literature is to a report authored by NERA Economic Consulting, on behalf of the Business Roundtable, in support of the Roundtable’s opposition to

¹⁴⁷ *Bus. Roundtable*, 647 F.3d at 1151.

¹⁴⁸ Case Comment, *supra* note 8, at 1093-95 (arguing that the court’s opinion established “unattainable standards” using arbitrary and capricious levels of review); Zaring, *supra* note 49 (calling the court’s analysis “the kind of searching inquiry no agency could survive”).

¹⁴⁹ *Bus. Roundtable*, 647 F.3d at 1150.

¹⁵⁰ Final Rule, *supra* note 4, at 56760-64.

¹⁵¹ *Bus. Roundtable*, 647 F.3d at 1150.

¹⁵² *Id.* at 1151 (citing Final Rule, *supra* note 4, at 56760 n.911).

¹⁵³ *Id.*

the Rule.¹⁵⁴ It is a commissioned document—akin to a legal brief—submitted to the SEC in support of the Roundtable’s comments. The court’s sole piece of evidence taken from this commissioned report is the following claim: “One commenter, for example, submitted an empirical study showing that ‘when dissident directors win board seats, those firms underperform peers by 19 to 40% over the two years following the proxy contest.’”¹⁵⁵

The court misstates the evidence. Buckberg and Macey, the authors of the purported “empirical study,” did not submit an empirical study of their own. Instead, they simply summarized the results of three other studies.¹⁵⁶ All the data from the three studies comes from proxy contests that occurred prior to 1990.¹⁵⁷ The market’s perspective on proxy activity has changed significantly over time, and data from the 1960s and 1970s may well not be representative of activity twenty-five, thirty, or forty years later.¹⁵⁸ Second, these studies vary in terms of their empirical results. Ikenberry and Lakonishok do find significant negative returns at 24 months when dissidents are successful; however, the negative results are strongest when dissidents capture a majority of the

¹⁵⁴ Elaine Buckberg & Jonathan Macey, *Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness, and Capital Formation in Support of Comments by Business Roundtable*, (Aug. 17, 2009), http://www.nera.com/upload/Buckberg_Macey_Report_FINAL.pdf.

¹⁵⁵ *Bus. Roundtable*, 647 F.3d at 1151 (citing Buckberg & Macey, *supra* note 153, at 9).

¹⁵⁶ See Buckberg & Macey, *supra* note 154, at 9 (citing Lisa F. Borstadt & Thomas J. Zwirlein, *The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance*, FIN. MGMT., Fall 1992; David Ikenberry & Josef Lakonishok, *Corporate Governance through the Proxy Contest: Evidence and Implications*, 66 J. BUS. 405, 420 (1993); and Michael Fleming, *New Evidence on the Effectiveness of the Proxy Mechanism*, (Federal Reserve Bank of New York Research Paper No. 9503), (Mar. 1995), available at http://www.newyorkfed.org/research/staff_reports/research_papers/9503.pdf).

As Steven Davidoff has pointed out: “Ms. Buckberg and Mr. Macey merely state in their letter that they are summarizing the aggregate results of three other studies from the early 1990s that examine companies from the 1960s to 1988. In this light, it is hard to see what the D.C. Circuit’s complaint is since it does not appear that the judges even looked at these underlying studies to assess their relevance.” Davidoff, *supra* note 8.

¹⁵⁷ See Borstadt & Zwirlein, *supra* note 156, at 24 (proxy contests from 1962 through 1986); Ikenberry & Lakonishok, *supra* note 156, at 408 (contests between 1968 and 1988); Fleming, *supra* note 156, at 4 (contests from 1977 through 1988).

¹⁵⁸ Cf. Roberta Romano, *After the Revolution in Corporate Law*, 55 J. LEGAL EDUC. 342, 342 (2005) (“The revolution in corporate law has been so thorough and profound that those working in the field today would have considerable difficulty recognizing what it was twenty-five to thirty years ago.”).

board,¹⁵⁹ which cannot happen through Rule 14a-11.¹⁶⁰ Borstadt and Zwirlein, in contrast, find a 28% drop in cumulative abnormal returns (CAR) for dissident victories, but the statistical significance is low, given the relatively small sample size.¹⁶¹ In addition, the 24-month point is the nadir; the CAR result improves to -16% at 36 months. Fleming's results are significantly more negative if the dissidents are appointed to their board seats (-24.72%) than if the dissidents are elected to their seats (-13.95%).¹⁶² Fleming also notes that "the removal of a few observations would be enough to eliminate the statistical significance in the observed decline."¹⁶³ Finally, all three studies do not see their empirical results as conclusive evidence that proxy contests destroy firm value. Ikenberry and Lakonishok note that proxy contests follow a period of deteriorating firm value: the five-year growth in these firms' operating income is 75% below that of the control firms.¹⁶⁴ They find the post-proxy results to be "unexpected and puzzling," and note that the evidence "suggests that shareholders are not rational when they cast their proxies."¹⁶⁵ In the alternative, Ikenberry and Lakonishok hypothesize that proxy contests may create overoptimism by investors and analysts, leading to disappointing returns.¹⁶⁶ If the firm is worse off than expected, dissidents may not be able to solve the firm's significant problems. This theory is seconded by Borstadt and Zwirlein, who suggest that "[i]t may be that dissidents are more likely to win control of firms that are in very bad operating shape," and that after they succeed at the ballot box, dissidents may be "little hope of saving an already sinking ship."¹⁶⁷ Moreover, these results do not keep Borstadt and Zwirlein being overall sanguine about proxy contests; they found "positive and significant abnormal returns realized over the proxy contest period for firms that were not later taken over."¹⁶⁸ These abnormal gains were not lost in the post-contest period.¹⁶⁹

¹⁵⁹ Ikenberry & Lakonishok, *supra* note 156, at 421 (cumulative abnormal return of -28.6% when dissidents gain at least one seat, versus -41.6% when dissidents gain control).

¹⁶⁰ Rule 14a-11 (limiting the percentage of seats to 25 percent of the seats up for election, and requiring nominating shareholders to disclaim any interest in capturing control).

¹⁶¹ Borstadt & Zwirlein, *supra* note 156, at 29 ("Although the magnitude of the CAR is large at the annual intervals, the statistical significance is low.").

¹⁶² Fleming, *supra* note 142, at 17.

¹⁶³ *Id.* at 18.

¹⁶⁴ Ikenberry & Lakonishok, *supra* note 156, at 432.

¹⁶⁵ *Id.* at 433.

¹⁶⁶ *Id.* at 433.

¹⁶⁷ Borstadt & Zwirlein, *supra* note 156, at 30.

¹⁶⁸ *Id.* at 31. In fact, the Borstadt and Zwirlein article is cited in a number of articles as evidence for the positive effects of proxy contests. See Lucian

The foregoing discussion is meant to demonstrate the complexities in using this group of empirical studies to enjoin the SEC's proxy-access rule. There are questions as to the sample size of dissident victories; issues of the relevance of proxy battles from the 1960s, 1970s, and 1980s; and disagreement as to the meaning of the results that were found. And these are the studies that Buckberg and Macey relied upon in making the case against proxy access's positive impact on firm performance. Other studies, published in a prestigious peer-review financial journal, have found that proxy contests increase firm value.¹⁷⁰ And regardless of

Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 712 & n. 68 (2007) (citing Borstadt and Zvirlein for the proposition that "empirical studies consistently found that proxy fights are associated with accompanying increase in shareholder wealth"); Roberta Romano, *Less is More: Making Institutional Activism a Valuable Mechanism for Corporate Governance*, 18 YALE J. ON REG. 174, 182 & n.20 (2001) (citing Borstadt and Zvirlein for the proposition that "proxy fights are not typically waged over marginal matters, and the empirical literature has consistently identified significant positive wealth effects from this activity").

¹⁶⁹ Borstadt & Zvirlein, *supra* note 156, at 31. Fleming similarly found that the threat of a proxy contest was associated with significant increases in firm value when the . Fleming, *supra* note 156, at 10-11 & tbl.4.

¹⁷⁰ Harry DeAngelo & Linda DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations*, 23 J. FIN. ECON. 29, 30 (1989); Peter Dodd & Jerold B. Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 J. FIN. ECON. 401, 402 (1983); J. Harold Mulherin & Annette B. Poulsen, *Proxy Contests and Corporate Change: Implications for Shareholder Wealth*, 47 J. FIN. ECON. 279, 280 (1998).

Neither the SEC nor the *Business Roundtable* court discussed a set of empirical studies designed to test whether the market thought that the SEC's proposal was a good idea. Two studies found that markets reacted negatively to the proposal. See Ali C. Akyol et al., *Shareholders in the Boardroom: Wealth Effects of the SEC's Proposal to Facilitate Nominations*, 46 J. FIN. & QUANTITATIVE ANALYSIS (forthcoming 2012), available at <http://ssrn.com/abstract=1526081>; David F. Larcker et al., *The Regulation of Corporate Governance* (May 3, 2010) (unpublished manuscript), available at http://rockcenter.stanford.edu/wp-content/uploads/2010/05/The-Regulation-of-Corporate-Governance_Larcker.pdf. However, the methodologies of these studies have been criticized. See Fisch, *supra* note 9, at 477 n.254 ("A combination of problematic coding decisions and confounding events raises serious doubts about the studies' empirical claims."). In addition, another study that came out after the regulation was enacted but before *Business Roundtable* found that firms that would have been most affected by the proxy access rule lost shareholder value when the SEC decided to delay implementation of the rule. Bo Becker, Daniel Bergstresser & Guhan Subramanian, *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable Challenge*, Working Paper, Jan. 19, 2012, at: <http://www.hbs.edu/research/pdf/11-052.pdf>. The study was discussed in late 2010. Steven M. Davidoff, *The Heated Debate over Proxy Access*, N.Y. TIMES DEALBOOK, Nov. 3, 2010, at: <http://dealbook.nytimes.com/2010/11/02/the-heated-debate-over-proxy-access/>. There is a meta-analysis question about these studies, even assuming that one or the other side is correct: namely, why should we accord special significance to the market's views at any particular time about

how these studies shake out, they are all examining something that, while similar, is not identical to what the SEC is proposing in this rule. Any study of shareholder-funded proxy challenges is not directly comparable to Rule 14a-11. So no empirical research of those proxy contests can be definitive. Moreover, studies that go beyond proxy contests in the prior century may also be instructive; what role should they play? Proponents of Rule 14a-11 marshaled empirical support for increasing shareholder power as a way to unlock greater share value.¹⁷¹ This body of empirical research is voluminous compared to the proxy contest studies discussed by the court, and its findings are arguably more relevant to Rule 14a-11 than the limited proxy contest research.

Respected legal academics have criticized Rule 14a-11 largely for its ineffectuality.¹⁷² Using empirical evidence about participation and share holdings, they have recounted the limitations on proxy access through Rule 11—three-percent ownership for three years—and noted the shallowness of this pool of potential proxy-access users.¹⁷³ Moreover, the assumptions upon which the limitations are based—for example, that longer term shareholders have a better sense of the company’s interests over time—have themselves been challenged empirically.¹⁷⁴ But the SEC recognized the limitations of its rule and provided a justification for the rule’s particular balancing of competing considerations.¹⁷⁵ These normative choices are endemic. For example, while the three-year rule may seem arbitrary, so would any rule drawing some line based on the length of the holding. But the notion that the 2008 financial crisis was caused in part by short-term profit maximization has received enough academic and popular support to support policies based on this justification.¹⁷⁶

the effects of the rule? Given the timing of these studies and their focus, we do not fault the SEC for failing to consider them. *But see* Fisch, *supra* note 9, at 477-78 (attributing the failure to consider these studies as a potential “sandbagging” by the SEC of its economic analysis).

¹⁷¹ See Final Rule, *supra* note 4, at 56,761 n.914.

¹⁷² Fisch, *supra* note 9, at 482 (finding that the SEC choose to enact a rule with “no consequences”); Kahan & Rock, *supra* note 9, at 1431-33.

¹⁷³ Fisch, *supra* note 9, at 458-66; Kahan & Rock, *supra* note 9, at 1420-25.

¹⁷⁴ See Xuemin (Sterling) Yan & Zhe Zhang, *Institutional Investors and Equity Returns: Are Short-Term Institutions Better Informed?*, 22 REV. FIN. STUD. 893, 920-22 (2009) (finding that trading activity by short-term institutional investors provides a reliable forecast of future returns), cited in Fisch, *supra* note 9, at 464 n.183.

¹⁷⁵ Final Rule, *supra* note 4, at 56,688-93.

¹⁷⁶ See, e.g., Kent Greenfield, *The Puzzle of Short-Termism*, 46 WAKE FOREST L. REV. 627, 629 (2011) (“Among the competing theories on the cause of the financial collapse—the over-dependence on derivatives, the overuse of leverage, the culture of greed and entitlement in the finance industry, just to name a few—a focus on the short term is an omnipresent narrative thread.”).

Thus, the fundamental error in the D.C. Circuit's opinion in *Business Roundtable* is the presumption that the Commission must have more than "mixed" empirical research in order to justify its rule.¹⁷⁷ Without the rule being enacted in a parallel universe to our own, there will never be empirical evidence that is more than "mixed" on this issue.¹⁷⁸ Academics, of course, should delve into the weeds to determine whether a particular study chose the proper sample size, controlled for the appropriate variables, and reached the right conclusions based on the data. But when academics using proper research methods have come to conflicting conclusions about empirical results, it is quixotic for agencies and courts to endeavor to find one true answer. The SEC sorted through the research to make a case for proxy access while acknowledging the limitations of that research.¹⁷⁹ The D.C. Circuit, by contrast, found the rule "not sufficiently supported" by the empirical data based on its own cursory review of a commissioned summary.¹⁸⁰ The contrast is striking. The *Business Roundtable* opinion demonstrates not only a failure to analyze the relevant research, but also a failure to understand the limits of that research to the question at hand.

B. Bad Theory

The SEC's justification for Rule 14a-11 is based partially on empirics, but mostly on theory. The empirical case, discussed above,¹⁸¹ is that companies do better when shareholders bring proxy challenges against underperforming boards. The theory

¹⁷⁷ See Davidoff, *supra* note 8 ("In truth, there is no definitive empirical evidence on this issue and it is likely will not be any. The issue of how and when director nominations influence boards is probably impossible to empirically prove without doubt. But the D.C. Circuit opinion seems to require such empirical proof.").

¹⁷⁸ One professor supported the rule, inasmuch as it would provide data going forward as to its efficiency. Eric Talley, *Proxy Access Forum*, CONGLOMERATE BLOG, (Aug. 26, 2010), <http://www.theconglomerate.org/2010/08/viewed-through-the-lens-of-editorial-pages-wednesdays-rule-changewas-a-watershed-event-shareholder-activists-have-been-c.html> ("Some rule changes – and particularly non-voluntary rule changes such as the new Rule 14a-11 – have the potential merit of creating natural experiments that add to the stock of information for future researchers, policy makers, regulators and investors. That dynamic value may justify their adoption in close cases, even if one's knee-jerk judgment – based exclusively on currently available static information – would tilt ambivalently towards preserving the status quo. At the very least, if we're genuinely interested in maximizing 'long term shareholder value' (a topic that may be ripe for another debate, another time), the benefit of modest regulatory experimentation deserves a seat at the prescriptive table.").

¹⁷⁹ See, e.g., Final Rule, *supra* note 4, at 56,760 n.911.

¹⁸⁰ *Bus. Roundtable*, 647 F.3d at 1150-51.

¹⁸¹ See part III.A *supra*.

behind this empirical evidence is that the board (and its appointed officers), despite being the elected representatives of the shareholders, may in fact act in its own interest. Shareholders suffer agency costs from having a group with potentially differing concerns make decisions on their behalf. The ability of shareholders to choose their representatives is thus critical in mitigating agency costs.¹⁸²

In theory, shareholders would enforce their will on their representatives as most electorates do: through elections. Shareholders generally vote every year for the entire board.¹⁸³ If the directors were acting out of self-interest or doing a poor job running the company, the shareholders could simply elect a different set of candidates who would, hopefully, do a better job. However, it has proven difficult to turn this relatively straightforward theory into reality. The foundational work of modern corporate law established the paradigm of separation of ownership from control: namely, the separation of shareholders from managers.¹⁸⁴ And the basic work of corporate law and economics further develops these ideas through the concept of the nexus of contracts and the difficulty of agency costs.¹⁸⁵ The important developments in corporate law theory and practice have almost all concerned efforts to resolve this tension between shareholder primacy and managerial control.

Shareholders face several critical challenges in proposing candidates outside of those nominated by the incumbent board. First, they face the problem of the commons: any time, money, or initiative they expend in improving the company will redound to

¹⁸² The Delaware Chancery has characterized the right to vote more in terms of legitimacy than economic efficiency:

The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. . . . It has, for a long time, been conventional to dismiss the stockholder vote as a vestige or ritual of little practical importance. . . . [W]hether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory that legitimated the exercise of power by some (directors and officers) over vast aggregations of property that they do not own.

Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

¹⁸³ Staggered boards are an exception; directors on staggered boards have two- or three-year terms, and generally are up for reelection on a rotating basis.

¹⁸⁴ ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 4 (1932).

¹⁸⁵ Jensen & Meckling, *supra* note 127. See also ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* xii (1993) (“Ever since Berle and Means, the central issue of corporate law has been how to create a legal structure that monitors management.”).

the benefit of the whole. If the shareholder owns 100% of the company, she will capture 100% of the fruits of her labor. However, if she only owns one percent—a huge sum for most public companies—she will carry all the costs but only capture one percent of the benefits. Unless she expects to earn back those costs, it is economically irrational for the one-percent shareholder to expend any time or money on improving the company, even if the overall gains would dwarf the individual costs.¹⁸⁶ Second, shareholders under the current system face much higher costs in nominating candidates than do the incumbent board members. In order to run for a director position, any candidate outside of the board's official proxy process must essentially create her own ballots and then provide them to shareholders to use in the voting process. There is no uniform ballot; instead, "outside" candidates provide their own proxies and disclose the information required by federal securities regulation. These substantial costs mean that most shareholders never nominate candidates, even if those candidates would be superior directors. The math is simple: the board gets its proxy ballot paid for by the corporation, but board opponents do not. That is why proxy ballot access for shareholders has been on the SEC's radar screen for most of its existence. Proxy access reduces the costs of participation, which makes it more likely that shareholders will participate more actively in governance. The theory is fairly straightforward.¹⁸⁷

How does the *Business Roundtable v. SEC* opinion refute this basic economic theory? The court made two counterarguments. First, it found that the Commission had underappreciated the costs that incumbent boards would incur in trying to defeat the "dissident" shareholder nominees. Second, it argued that Rule 14a-11 would cater to union and state pension funds who would

¹⁸⁶ To illustrate this: shareholder X owns one percent of Company Y Inc., a company worth \$100 million. If X runs for the board of directors and implements reforms to the business, Y Inc. will increase in value 20% to \$120 million. However, X would only capture \$200,000 of those gains. If X's costs to secure the seat are more than \$200,000, X will not pursue those reforms, even though the company would increase in value by \$20 million.

¹⁸⁷ Lee Harris has argued that the results of corporate elections are based not on the directors' ability to enhance shareholder value, but rather on their amount they spend on the campaign. Lee Harris, *The Politics of Shareholder Voting*, 86 N.Y.U. L. REV. 1761, 1782-87 (2011). He maintains that true reform would require some system of subsidizing campaign expenses for challengers, akin to public financing for political elections. *Id.* at 1807; *see also* Lee Harris, *Shareholder Campaign Funds: A Campaign Subsidy Scheme for Corporate Elections*, 58 UCLA L. REV. 167 (2010). In addition, Yair Listokin has found an abnormal number of incumbent board victories in his study of close elections, suggesting some form of advantage for incumbents. Yair Listokin, *Management Always Wins the Close Ones*, 10 AM. L. & ECON. REV. 159 (2008).

use the process to badger for reforms unrelated to overall shareholder value.

Regarding the incumbent board's campaign costs, the Commission recognized that "it can reasonably be expected that the boards of some companies likely would oppose the election of shareholder nominees."¹⁸⁸ It also cited to commenters who suggested that the costs of proxy contests ranged from \$800,000 to \$14 million.¹⁸⁹ However, the Commission noted that these costs were not required under Rule 14a-11, and that boards might very well choose to expend fewer resources. This contention drew the ire of the court, which found that "the Commission's prediction directors might choose not to oppose shareholder nominees had no basis beyond mere speculation."¹⁹⁰ The court recognized that, under economic theory, a rational board will forgo an expensive proxy campaign "if it believes the cost of opposition would exceed the cost to the company of the board's preferred candidate losing the election, discounted by the probability of that happening."¹⁹¹ However, the court acceded to the logic of the American Bar Association Committee of Federal Regulation of Securities, which essentially argued that boards will always have a fiduciary duty to fiercely oppose shareholder nominees. How so? Well, the comment argued, if the board determines that the shareholder nominee is not as good as their nominee, then the board "will be compelled by its fiduciary duty to make an appropriate effort to oppose the nominee."¹⁹² But—of course—in every instance, the shareholder nominee will be someone who was not chosen by the board as its nominee. So according to the court, the incumbent board has a fiduciary duty to campaign vigorously against any and all "dissident" nominees, since the incumbent nominees will always be better for the corporation.

At this point it is helpful to take a step back and remind ourselves of the enterprise. Rule 14a-11 allows shareholders to save the costs in buying their own proxy materials by using the company's proxy materials instead. It thus may facilitate such nominees and thereby increase their number. But Rule 14a-11 does not change the underlying fact of the elections themselves; shareholders have always been free to run proxy contests against the board's nominees, and the board has always been free to use the corporate coffers for its campaign—within the limits

¹⁸⁸ Final Rule, *supra* note 4, at 56770.

¹⁸⁹ *Id.*

¹⁹⁰ *Bus. Roundtable*, 647 F.3d at 1150.

¹⁹¹ *Id.*

¹⁹² *Id.* (quoting Letter from Jeffrey W. Rubin, Comm. on Fed. Regulation of Securities, Am. Bar Ass'n, to SEC 35 (Aug. 31, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-456.pdf>).

proscribed by fiduciary duty.¹⁹³ To that extent, the Commission is correct when it characterizes the costs of campaign as inherent in the underlying elections required by state corporate law.¹⁹⁴

In fact, by making it easier for shareholders to participate in elections, Rule 14a-11 may, somewhat counter-intuitively, decrease the number of contested elections. Corporate boards, of course, never *have* to wait for disgruntled shareholders to challenge them in an election. They can, instead, mollify potential rivals by being more alert and responsive to shareholder concerns that might prompt a fight. Or boards might opt to include shareholder nominees on their own slates. Making the corporate governance system more responsive could very well encourage self-interested corporate board member—as it has for generations of politicians—to pay a little closer attention to the desires of the electorate. And while there might be dangers to an overresponsive system of governance, that really isn't of any concern here with the limitations built into Rule 14a-11 challenges.

And even if corporate management ends up having to deal with more contested elections under Rule 14a-11, that alone should not have troubled the court. Focusing on the costs of the election for the incumbents is like focusing on the costs of political campaigns to incumbents in assessing whether we want to facilitate challenges to the incumbents. Electoral campaigns allow for competition between rival candidates to choose the best possible nominee. Yes, it would be less costly if we just declared the incumbent the winner—but that would defeat the point of having an election in the first place.

Unlike the Commission,¹⁹⁵ the court does not endeavor to take into account the overall costs and benefits of the rule. It instead simply claims that the Commission failed to take sufficient account of the costs that incumbent boards would incur in fighting for their nominees.¹⁹⁶ But the court never mentions the much larger

¹⁹³ According to Delaware law, “where reasonable expenditures are in the interest of an intelligent exercise of judgment on the part of the stockholders upon policies to be pursued, the expenditures are proper; but where the expenditures are solely in the personal interest of the directors to maintain themselves in office, expenditures made in their campaign for proxies are not proper.” *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 171 A. 226, 228 (Del. Ch. 1934). As the court acknowledged in that case, “difficulty is often bound to arise when it is sought in such cases as this to draw the line between what is proper and what is improper.” *Id.* See also *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 128 N.E.2d 291 (N.Y. 1955).

¹⁹⁴ Final Rule, *supra* note 4, at 56,770.

¹⁹⁵ Final Rule, *supra* note 4, at 56,754-71.

¹⁹⁶ It is not really clear from the opinion what the court actually wanted from the Commission here. The court “agree[d] with the petitioners that the Commission’s prediction directors might choose not to oppose shareholder nominees had no basis beyond mere speculation.” *Bus. Roundtable*, 647 F.3d at

potential benefits that shareholders would get from having more competitive elections. Shareholders elect directors. It is the key structural element of shareholder primacy, which is the theoretical foundation for the law & economics of corporate law. Yet *Business Roundtable v. SEC* treats a contested election as a cost to be borne by the incumbent board, rather than a critical component of corporate governance.

Let us say it again—shareholder elections have been a cornerstone not only of corporate law doctrine, but in fact of the *law and economics* perspective on corporate law. In order for the board to align its interests with those of the shareholders, the electoral process needs to work. Shareholder preferences need to be meaningfully reflected in electoral outcomes. Law and economics scholars have worked at designing ways for shareholders to have a stronger voice in the process in order to facilitate shareholder wealth maximization. The need for the incumbent board to protect itself against shareholder insurgents has never been high on the agenda. The fact that an incumbent board can reimburse itself at all for its campaign expenses is a somewhat controversial one.¹⁹⁷ Rather than noting that Rule 14a-11 would reduce costs for shareholders in exercising their right to nominate candidates, the *Business Roundtable* court emphasizes the costs boards will have to expend in fighting them off.

Why does the court reject basic economic theory in favor of supporting incumbent boards? Perhaps because the court is predisposed to think that the shareholder nominees who will take advantage of Rule 14a-11 deserve to be defeated. In our view, the crux of the court's opinion is its section on "Shareholders with Special Interests"—namely, "unions and state and local governments whose interests in jobs may well be greater than their interests in share value."¹⁹⁸ Because of their "special" interests, the court fears that such shareholders will use Rule 14a-11 to "pursue self-interested objectives rather than the goal of maximizing shareholder value, and will likely cause companies to incur costs even when their nominee is unlikely to be elected."¹⁹⁹

1150. However, the Commission suggested this was a mitigating possibility; it did not suggest that incumbent boards would forego proxy campaigns. Instead, the Commission only argued that the costs might be limited. Final Rule, *supra* note 4, at 56,770. Although the court cited the petitioners' claim that the failure to estimate the exact costs of such campaigns was arbitrary, the court did not specifically endorse this claim. *Bus. Roundtable*, 647 F.3d at 1150.

¹⁹⁷ See, e.g., WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 182 (2003) ("...[A]uthorizing the board to expend corporate funds on its own re-election seems to permit a kind of self-dealing.").

¹⁹⁸ *Bus. Roundtable*, 647 F.3d at 1151-52.

¹⁹⁹ *Id.* at 1152.

The court accused the Commission of acting arbitrarily by “ducking serious evaluation of the costs that could be imposed . . . by shareholders representing special interests.”²⁰⁰

For a court that had earlier been so concerned with empirical support, the claim that union and pension fund shareholders will use their shares to pursue special interests is laughably lacking. As its authority, the court cites to the comments from the Business Roundtable itself, which provides the following quote: “[S]tate governments and labor unions . . . often appear to be driven by concerns other than a desire to increase the economic performance of the companies in which they invest.”²⁰¹ The quote is taken from an article by the Chancellor of the Delaware Court of Chancery.²⁰² The article does not provide a footnote for this statement, and there is no authority presented in support. The claim itself is rather couched, qualified by “often” and “appears to be.” In fact, the Chancellor’s entire article is not written as his own views, but rather as a missive based upon a fictionalized perspective of an “open-minded corporate law ‘traditionalist.’”²⁰³ As Chancellor Strine emphasizes, “[t]hat viewpoint should not be confused as representing my own.”²⁰⁴ Regardless of whether this is meant to present an unreliable narrator,²⁰⁵ it certainly makes the article an exercise in rhetoric. It seems fairer to say that Chancellor Strine’s statement is something that the “traditionalist” would believe—not necessarily something grounded in demonstrated reality.²⁰⁶ The use of “appears to be” echoes this notion.

The bogeyman of unions and pension funds running amok is popular in a certain segment of corporate law literature.²⁰⁷

²⁰⁰ *Id.*

²⁰¹ *Id.* (citing Detailed Comments of Business Roundtable on the Proposed Election Contest Rules and the Proposed Amendment to the Shareholder Proposal Rules 102 (August 17, 2009), available at http://businessroundtable.org/uploads/hearingsletters/downloads/BRT_Comment_Letter_to_SEC_on_File_No_S7-10-09.pdf).

²⁰² Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk’s Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1765 (2006). At the time, Chancellor Strine was a vice-chancellor.

²⁰³ *Id.* at 1759.

²⁰⁴ *Id.*

²⁰⁵ *See, e.g.*, AGATHA CHRISTIE, *THE MURDER OF ROGER ACKROYD* (1926).

²⁰⁶ *See also* J. Robert Brown, *Shareholder Access and Uneconomic Economic Analysis: Business Roundtable v. SEC*, DENV. U. L. REV. ONLINE, Sept. 30, 2011, at: <http://www.denverlawreview.org/practitioners-pieces/2011/9/30/shareholder-access-and-uneconomic-economic-analysis-business.html> (noting that Chancellor Strine “was commenting on differences among shareholders, not the use of access”).

²⁰⁷ *See, e.g.*, STEPHEN BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* 229 (2008) (“Public employee pension funds are vulnerable to being used as a vehicle for advancing political/social goals of the

However, it is similarly unsubstantiated there. The most common example of “special” shareholders using their power to affect firm governance—in a way that harms other shareholders—is the campaign by CalPERS and the United Food and Commercial Workers (UFCW) to withhold shareholder support for certain Safeway directors.²⁰⁸ The campaign allegedly targeted these directors because of Safeway’s hard-line negotiations with the UFCW. In the end, however, only seventeen percent of the shares voted against the targeted directors.²⁰⁹

The CalPERS-Safeway example has been used over and over to demonstrate the potential for unions and pension funds to pressure boards into caving to labor demands.²¹⁰ But the example itself demonstrates the *lack* of such potential. CalPERS and the other pension funds involved had legitimate corporate governance concerns to raise along with their union-oriented concerns; they did not nakedly assert nonshareholder interests.²¹¹ Indeed, why

fund trustees that are unrelated to shareholder interests generally.”); Joseph A. Grundfest, *The SEC’s Proposed Proxy Access Rules: Politics, Economics, and Law*, 65 BUS. LAW. 361, 378-83 (2010) (singling out labor unions and public pension funds a special-interest shareholders); Romano, *supra* note 153, at 231-32 (arguing that union and public pension fund managers use shareholder proposals to accrue “private benefits”); Larry Ribstein, The “Shareholder Democracy” Scam, IDEOBLOG, (Oct. 27, 2006), at http://busmovie.typepad.com/ideoblog/2006/10/the_shareholder.html (“It should be obvious to anybody who cares to look past the rhetoric that the unions are seeking bargaining leverage on behalf of their members, and to ensure their own survival. They are *not* seeking to represent the interests of investors generally.”); Mark J. Roe, *The Corporate Shareholder’s Vote and Its Political Economy, in Delaware and Washington*, Working Paper, Nov. 20, 2011, at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1884110 (referring to “agenda-driven activists, such as CalPERS and other state pension funds, as having pernicious and costly side-agendas” apart from those of “financial” shareholders).

²⁰⁸ See Grundfest, *supra* note 207, at 382-83.

²⁰⁹ *Id.* at 383. Moreover, the directors would have still been reelected, even if a majority had voted to withhold their votes.

²¹⁰ BAINBRIDGE, *supra* note 207, at 229; Anabtawi, *supra* note 117, at 589-90; Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1285-86 (2008); Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877, 883 (2010); Grundfest, *supra* note 207, at 382-83; John F. Olson, *Reflections on a Visit to Leo Strine’s Peaceable Kingdom*, 33 J. CORP. L. 73, 76-77 (2007); Mark J. Roe, *Delaware’s Politics*, 118 HARV. L. REV. 2491, 2524-25 (2005); J.W. Verret, *Defending against Shareholder Proxy Access: Delaware’s Future Reviewing Company Defenses in the Era of Dodd-Frank*, 36 J. CORP. L. 391, 397 (2011); David H. Webber, *Is “Pay-to-Play” Driving Public Pension Fund Activism in Securities Class Actions? An Empirical Study*, 90 B.U. L. REV. 2031, 2071 (2010).

²¹¹ Marc Lifsher, *CalPERS to Withhold Votes on Safeway CEO*, L.A. TIMES, April 8, 2004, at: <http://articles.latimes.com/2004/apr/08/business/fi-calpers8> (“CalPERS said it would withhold its votes for Safeway Chairman and Chief

would they?—they were also shareholders. Their exercise of power netted only seventeen percent of the total shareholder vote, and also led to the ouster of the CalPERS chair who had orchestrated the campaign.²¹² The situation was, in fact, a total catastrophe for CalPERS. It is hardly evidence that unions and pension funds will exercise their ballot box power to crush their fellow shareholders. Moreover, beyond this anecdote, the evidence is that union and pension fund shareholders have been aligned with their fellow shareholders in seeking corporate governance reforms.²¹³

There's a reason why "special interest" shareholders have supported reforms that support overall shareholder value rather than their special interests: they would not otherwise be enacted. Efforts by one group of shareholders to elect a director that would cater to their unique interests would be met with indifference or hostility from their fellow shareholders. The *Business Roundtable* court fails to explain how union and pension fund shareholders could ever use Rule 14a-11 to elect special-interest directors without majority support. The numbers do not add up. There are only two alternatives: (1) that shareholders will irrationally vote against their interests, or (2) special-interest candidates will consistently lose. The court presents no theory as to an irrational

Executive Steven Burd because of a 60% drop in Safeway's stock since early 2001 that the pension fund said wiped out \$20 billion in market value. CalPERS officials also cited what they described as conflicts of interest and a lack of responsiveness to shareholder concerns.").

²¹² Tom Petrino, *Business Applauds Shake-Up at CalPERS*, L.A. TIMES, Dec. 2, 2004, at A1.

²¹³ Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1019-20 (1998) ("In most cases, it is hard to find a socialist or proletarian plot in what unions are doing with their shares. Rather, labor activism is a model for any large institutional investor attempting to maximize return on capital."). One empirical study has found that AFL-CIO affiliated shareholders are more likely to support director nominees by the incumbent board once the AFL-CIO no longer represents workers at a given firm. Ashwini K. Agrawal, *Corporate Governance Objectives of Labor Union Shareholders*, REV. FIN. STUD. (forthcoming), at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1285084. Agrawal argues that this divergence represents governance objectives that are "motivated by worker interests rather than equity value maximization alone." *Id.* at 2. The study focused on the split between the AFL-CIO and the Change to Win coalition of unions, and examined the behavior of AFL-CIO funds with respect to directors at Change to Win companies. *Id.* at 3-4, 7-8. Overall, Agrawal found that the AFL-CIO funds voted for director nominees 65% of the time and a Change to Win union (the Carpenters) voted 75% of the time, while three different index funds supported the director nominees between 89%–98% of the time. *Id.* at 35 tbl. 1. Agrawal assumes, however, that the index funds' votes reflect a policy of shareholder wealth maximization. He does not demonstrate why a vote for incumbent directors equals a vote for shareholder wealth maximization; it could, in fact, represent the opposite.

electorate, but does contend that a corporation may incur costs even without shareholder victories. It raises the specter of a board “succumbing to the demands, unrelated to increasing value, of a special interest shareholder threatening to nominate a director.”²¹⁴ However, it cites no instances of such a power play, nor does it explain why in theory a board would cave. The court also notes that special-interest shareholders “will likely cause companies to incur costs even when their nominee is unlikely to be elected.”²¹⁵ However, the court does not explain why shareholders would send up nominees unlikely to be elected, other than to impose costs (which is, of course, against all shareholder interests, including their own). Although Rule 14a-11 reduces the costs of nominating director candidates, it does not eliminate them entirely, and it would be economically irrational for special-interest shareholders to incur repeated nomination costs if the result is consistent electoral defeat.²¹⁶

Thus, the court’s decision in *Business Roundtable* rests on economic theory that: (a) discounts the importance of the shareholder vote in corporate governance; (b) looks only at the campaign costs to incumbents when calculating the overall

²¹⁴ *Bus. Roundtable*, 647 F.3d at 1152.

²¹⁵ *Id.*

²¹⁶ Joseph Grundfest has provided a theory (unmentioned by the court) arguing that union and pension fund shareholders could use Rule 14a-11 as a “megaphone” to get across their message and, in some cases, secure concessions from sensitive boards. Grundfest, *supra* note 207, at 378-83. Grundfest asserts that these shareholders can use the nomination process to gain additional publicity “at very little cost” and “need not even come close to winning.” *Id.* at 379. He cites to the “significant press coverage” that the first proxy access candidates will get, or that will accrue to those candidates touting “controversial or novel proposals.” We think that this concern is overstated and, at best, short-term. It would eventually be self-defeating. However, it is instructive (and perhaps eye-opening) to see the parade of horrors that Grundfest trots out:

Consider a board candidate who wants to limit the export of jobs to foreign factories, or to close down foreign factories in order to bring manufacturing jobs back to America. Consider a candidate who wants to cap all executive salaries at a multiple of the average hourly wage of the rank and file. Consider a candidate who wants the company voluntarily to comply with emissions standards that reduce global warming but that place the corporation at a competitive disadvantage in the marketplace.

Id. at 381. Grundfest also alludes to the possibility that “eggshell directors” will collapse under the pressure of a dissident campaign and offer meaningful concessions to make the campaign go away. *Id.* at 382-83. His only example is Safeway—a failure—and his theory requires that directors will act irrationally to stave off some level of PR discomfort. Perhaps such eggshells should not be on the board to begin with.

efficiency of the shareholder franchise; (c) assumes directors will act irrationally in the face of challenges; and (d) assumes “special-interest” shareholders will irrationally waste their own and the corporation’s money in pursuit of fruitless campaigns. This collection of theories departs dramatically from the standard law and economics of corporate law, which assumes that shareholders and directors will act rationally, that agency costs are a natural byproduct of the separation of ownership and control, and that the shareholder franchise will increase overall efficiency.²¹⁷ Why does the *Business Roundtable* court—a court that ostensibly seeks to vindicate law and economics principles in its decision—depart so dramatically from law and economics foundations? The next section offers our theory.

IV. *Business Roundtable* and the Purpose of Democracy

Business Roundtable reveals just how far a sect of law and economics adherents has drifted from its own basic precepts. They actually distrust a more robust corporate democracy *because* the electoral outcomes are more likely to reflect underlying shareholder preferences. In a world of stifled democracy, theoreticians can make judgments about what the People would “really” want if they were freely able to express those preferences. So it was with the law and economics of corporate law: the “nexus of contract” theory was used to justify the existence of certain contractual features in the corporate landscape, while the “hypothetical contract” was used to justify the mandatory, non-contractual foundations.²¹⁸ Similarly, the notion of “shareholder homogeneity” enabled corporate law theorists to speak broadly about what shareholders (as a whole) would want.²¹⁹ If all shareholders are the same—or, at least, want the same things out of their shares—then the vote itself becomes almost secondary.

²¹⁷ EASTERBROOK & FISCHER, *supra* note 113, at 66-72 (defending the shareholder franchise); Hansmann & Kraakman, *supra* note 102, at 441 (finding that “as a consequence of both logic and experience, there is convergence on a consensus that the best means to this end (that is, the pursuit of aggregate social welfare) is to make corporate managers strongly accountable to shareholder interests and, at least in direct terms, only to those interests”).

²¹⁸ See Grant M. Hayden & Matthew T. Bodie, *The Uncorporation and the Unraveling of “Nexus of Contract” Theory*, 109 MICH. L. REV. 1127, 1131-32 (2011) (reviewing LARRY E. RIBSTEIN, *THE RISE OF THE UNCORPORATION* (2010)).

²¹⁹ See, e.g., EASTERBROOK & FISCHER, *supra* note 113, at 70 (emphasizing that shareholders are likely to have “similar if not identical” interests because “the shareholders of a given firm at a given time are a reasonably homogenous group”).

As has become increasingly clear, however, shareholders are not homogenous.²²⁰ A variety of different shareholder “types”—majority shareholders, shareholders with disproportionate voting rights, members of voting trusts, bribed shareholders, hedged shareholders, government shareholders, employee and management shareholders—have unique interests apart from their shareholder compadres.²²¹ Moreover, shareholders differ with respect to their definition of wealth maximization. A hedge fund looking for a quick return is different than an index fund looking to stay in the stock as long as it is listed. A shareholder seeking to maximize the value of this individual stock is different than a portfolio investor.²²² Shareholders might have conflicting opinions as to business and strategic decisions that shape the corporation’s present and future.²²³ And the notion that shareholders have a shared interest in wealth maximization is a simplifying assumption. Shareholders are heterogeneous with respect to their utility preferences in that these preferences do not match up directly with wealth. Shareholders – when assessed as individual people – all have individual utility preferences that go beyond maximization of one’s wealth.²²⁴

When scholars hold forth that special interest shareholders may advance goals that are unrelated to “shareholder interests generally,” they put the cart before the horse. The concept itself—“shareholder interests generally”—has no meaning until the preferences of actual shareholders are aggregated through some electoral process. It’s a mistake to think that any one version of shareholder wealth maximization has priority over all the others. It’s a bigger mistake for a court to adopt that singular version and enforce it. And it’s simply bad economics to ignore large swaths

²²⁰ Hayden & Bodie, *False Promise*, *supra* note 61, at 477-98.

²²¹ *Id.* at 477-92.

²²² Some commentators have suggested a normative system of portfolio wealth maximization, rather than share wealth maximization. Robert G. Hansen & John R. Lott, Jr., *Externalities and Corporate Objectives in a World with Diversified Shareholders/Consumers*, 31 J. FIN. & QUANT. ANALYSIS 43, 44 (1996). See also Greenwood, *supra* note 137, at 1056 (discussing the differences between the “corporate law” fictional shareholder and the “portfolio investor” shareholder).

²²³ For example, Hewlett-Packard shareholders recently battled over the wisdom of the merger between Hewlett-Packard and Compaq. Michael Brick & Steve Lohr, *Fiorina Claims Victory in Hewlett-Compaq Proxy Battle*, N.Y. TIMES, March 19, 2002. Hewlett-Packard director Walter Hewlett battled the rest of the company’s board and management over the merger, ultimately losing in a close election. Both sides agreed that the merger should be judged on its impact of Hewlett-Packard’s success, but they disagreed about whether the merger would help accomplish that goal. Hewlett and the company spent an estimated \$100 million in their efforts to persuade shareholders. *Id.*

²²⁴ For an in-depth discussion of the role of efficiency in the law and economics of corporate law, see Hayden & Ellis, *supra* note 50.

of individual preferences when they don't comply with a particular vision of the corporation. Standard economics instructs us to take preferences as they come. In almost every other situation, law and economics scholars positively fetishize individual preferences; here, they run away from them. Simple reflection should reveal that, when it comes down to it, there aren't any shareholders who seek to advance "shareholder interests generally." That, after all, is the board's job, and the way to keep it on task is to ensure that the election process is at least somewhat responsive to actual shareholders.

Of course, if there is no avenue for expressing these diverse preferences, there is no evidence of them on display. In closely-held corporations, shareholders' preferences conflict on a variety of levels: dividends, mergers, director seats, employment positions, and business plans. And these preferences play out in shareholder votes and board meetings. But the separation of ownership from control in public corporations has meant that the shareholder franchise is effectively irrelevant.²²⁵ If shareholders cannot efficiently mount opposition campaigns for director positions, these elections become exercises in rubber stamping. Rule 14a-11 was an attempt to break out of this dysfunctional pattern. It endeavored to reduce the costs of competing for directorships, and thereby encourage more candidates to enter the race.

We know from our basic review of preference aggregation that there are many ways in which a voting system can fall short of its goal of producing outcomes that meaningfully reflect the desires of relevant constituents.²²⁶ Sometimes there are barriers, both subtle and obvious, that prevent interested parties from voting. Sometimes the system assigns weight to votes in a way that skews outcomes in a particular direction. Sometimes votes are combined in ways that thwart the ability of certain groups of voters to have an equal opportunity to elect representatives of their choice. And, in some cases, voters are hindered in their ability to get their preferred candidates on the ballot during the slating process. A defect in any aspect of a voting system has the ability to distort the preference aggregating function of an election.

Here, even if contemporary corporate governance gets some things right (perhaps, for example, "one share, one vote" properly captures both the identity and proper weighting of corporate votes), it may still fall short when it comes to the slating process. A slating process that unduly restricts the ability of candidates to make it onto a ballot is, generally, a problem.²²⁷ And when one of

²²⁵ Bebchuk, *supra* note 168, at 682-94 (describing the lack of effective shareholder voting power).

²²⁶ See Part II, *supra* pages xx-xx.

²²⁷ See Hall, *supra* note 88.

the principal justifications for that restriction is based on the content of voter preferences, as it is in the case of “special interest” shareholders, we can be certain that the results will be skewed in a certain direction, distorting the preference aggregating function of the electoral process. In the political realm, we saw that the Supreme Court sometimes viewed political stability in the form of preserving the two-party system as an acceptable (though not uncontroversial) goal of state ballot access laws.²²⁸ But the existing scheme of corporate governance—the one that Rule 14a-11 was designed to modify—is nowhere close to suffering from the kind of unsteadiness that might justify more restrictive access to the corporate ballot. Indeed, the current system has all the stability (and democratic fairness) of a one-party state.

Which brings us to a little secret about those law and economics adherents who believe in shareholder homogeneity: they do not want real shareholder democracy. Shareholder wealth maximization is a fictional placeholder developed to replace the actual interests of the shareholders.²²⁹ If shareholders truly expressed their preferences through their votes, there would be no need for the norm of residual maximization. Instead, the board and management would be expected to follow the actual preferences of shareholders, rather than simply a presumed wealth maximization preference. Thus, we see the strange cycle that justifies the current stasis in shareholder democracy. Shareholders, we are told, will single-mindedly focus on increasing the residual as their sole preference for corporate policy. Because it is in the interests of all corporate stakeholders that the residual be maximized, we should give power to those who have a single-minded focus on such an outcome.²³⁰ However, actual shareholders may not all agree on one homogenized goal. If let loose to express their actual preferences, shareholders might express their preferences for a variety of interests beyond shareholder wealth maximization.²³¹ Because shareholder preferences are irrelevant to shareholder primacy, true shareholder democracy is actually a threat to the shareholder wealth maximization norm.

The *Business Roundtable* decision neatly illustrates this hostility. In its review of the Commission’s cost-benefit analysis, the court agreed that Rule 14a-11 “will mitigate collective action

²²⁸ See Part II, *supra* pages xx-xx.

²²⁹ Greenwood, *Fictional Shareholders*, *supra* note 137, at 1052 (“For fictional shareholders, whatever else the people behind them may want, all want to maximize the value of their shares.”).

²³⁰ EASTERBROOK & FISCHER, *supra* note 113, at 403.

²³¹ Greenwood, *supra* note 137, at 1052-53 (“If the corporation were run by and for real people, it would be a hotbed of political controversy. . . . If the real people disagree with the fictional representation, the real people may simply be disregarded as not real shareholders.”).

and free rider concerns, which can discourage a shareholder from exercising his right to nominate a director in a traditional proxy contest, and has the potential of creating the benefit of improved shareholder value.”²³² But the opinion never returned to these notions. Instead, it turned to the concrete costs of democracy for the incumbent board: namely, the costs of engaging in a meaningful board election, and the potential for “special” shareholders to abuse their right to enter elections.²³³ From the court’s perspective, democracy is a messy, expensive process in which outsiders may crash the party and ruin the whole thing. The Commission’s failure to recognize this was, in the court’s view, arbitrary and capricious.

But, of course, democracy *is* messy. Most, if not all, of us have been disappointed by its results at various points in our lives. Some corporate law scholars have argued that democracy should have only a minimal role to play in corporate governance, and that directors should have the authority of Platonic guardians over their shareholder subjects.²³⁴ However, mainstream law and economics has long defended the critical role of shareholder democracy within the overall framework of corporate governance.²³⁵ Shareholders need to hold directors accountable for failing to pursue shareholder interests. Otherwise, the corporation will be riven with agency costs.

The split between the ideas of shareholder wealth maximization and shareholder preference aggregation has led to the current split in the law and economics academy. One side maintains its faith that facilitating shareholder democracy will

²³² *Bus. Roundtable*, 647 F.3d at 1149 (citing Final Rule, *supra* note 4, at 56756, 56761).

²³³ *Bus. Roundtable*, 647 F.3d at 1149-52.

²³⁴ Bainbridge, *supra* note 107, at 560. Bainbridge supports the goal of shareholder wealth maximization but argues against greater shareholder input. *See id.*; Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006). He bases his argument primarily on the need for centralized and largely unreviewable discretion in order to maximize efficient business operations. *Id.* at 1749 (“Active investor involvement in corporate decisionmaking seems likely to disrupt the very mechanism that makes the widely held public corporation practicable: namely, the centralization of essentially nonreviewable decisionmaking authority in the board of directors. The chief economic virtue of the public corporation is . . . that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other constituencies.”). *See also* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 280 (1999) (discussing their “mediating hierarchs” approach to board leadership).

²³⁵ EASTERBROOK & FISCHER, *supra* note 113, at 63 (arguing that “the structure of voting—who votes, using what institutions—is contractual, and efficient, too”).

increase corporate efficiency and reduce overall agency costs.²³⁶ The other side now trusts the hypothetical shareholder more than actual shareholders when it comes to pursuing shareholder wealth maximization. Private equity funds which seek to buy out shareholders at a premium are to be encouraged. But shareholders within the company who want to exercise their democratic privileges are simply troublemakers. The D.C. Circuit has placed itself firmly in the second camp—and, we believe, inappropriately so.

CONCLUSION

Corporate law and economics scholarship has become adept at containing and eliding certain contradictions as to its basic principles. Corporations are contracts, except when they're not.²³⁷ Shareholders all have the same interests, except when they don't.²³⁸ And shareholder voting maximizes utility, except when it doesn't.²³⁹ The analysis in *Business Roundtable* provides a shoddy and simplified reflection of these principles; it should perhaps not be surprising that the contradictions therefore appear a bit more obvious.

It is one thing for scholars to debate contested issues using rival theories and indeterminate empirical data. It is quite another for the judiciary to strike down a regulation—one specifically endorsed by statute—based on one side's version of the theory and data. The *Business Roundtable* decision has ensconced a bad version of corporate law and economics into the Federal Reporters. And we fear that, unless it is corrected over time, this bad law and economics will cow regulatory agencies, particularly the SEC, into adhering to a crabbed and inchoate vision of corporate governance. Hopefully, criticism of the opinion will demonstrate that the court's errors need not be replicated by others.

²³⁶ See, e.g., Bebchuk, *supra* note 168.

²³⁷ Hayden & Bodie, *supra* note 218, at 1129-32.

²³⁸ Hayden & Bodie, *False Promise*, *supra* note 61, at 477-98.

²³⁹ Hayden & Ellis, *supra* note 50.