PROXY REFORM AS A MEANS OF INCREASING SHAREHOLDER PARTICIPATION IN CORPORATE GOVERNANCE: TOO LITTLE, BUT NOT TOO LATE

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INTRODUCTION

The current system of corporate governance in the United States is, at least in part, the product of fairly comprehensive state and federal regulation. The existing rules relating to corporate governance are based on certain assumptions about the nature of corporations, corporate management, and corporate shareholders, including the "inevitability" of shareholder passivity and directoral control.[1] An analysis of how corporations and corporate law have evolved and how the changing patterns of corporate governance reflect this evolution indicates that these assumptions may not be accurate.

The significance of any discrepancy between reality and the current

1. *See infra* notes 20-29 and accompanying text (discussing almost nonexistent role of shareholders in corporate governance under existing rules).

corporate law paradigm lies in the increasing evidence that prevailing corporate governance models are substantially flawed.[2] Directors of large American companies have been subject to increasing criticism for acting out of self-interest,[3] particularly in establishing or approving exorbitant executive compensation packages,[4] deciding to acquire other corporations,[5] and responding to takeover attempts and tender offers.[6] They are also criticized for inefficient decisionmaking.[7] If these criticisms are valid, they justify a reevaluation of the rules that institutionalize the prevailing model of corporate governance in this country.

Patterns of corporate control in American corporations share tremendous similarities. As a matter of state law, directors in public corporations have the ultimate say in the management of the corporation.[8] While outside directors[9] are increasingly prevalent,[10] a consistent pattern has developed where the dominant director, usually the Chairman of the Board, also serves as the corporation's Chief Executive Officer (CEO).[11] Moreover, outside directors are usually chosen based, at least in part, on perceptions about the extent

2. *See infra* notes 25-30 and accompanying text (finding that current corporate governance models lead to inefficient use of property).

3. *See infra* part II.A.

4. *See infra* part II.A.1.

5. *See infra* part II.A.2.

6. *See infra* part II.A.3.

7. *See infra* part II.B.

8. *See, e.g.*, CAL. CORP. CODE § 300(a) (West 1990) ("[T]he business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board."); DEL. CODE ANN. tit. 8, § 141(a) (1991) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."); N.Y. BUS. CORP. LAW § 701 (McKinney 1986) ("[T]he business of a corporation shall be managed under the direction of its board of directors . . . ."); TEX. BUS. CORP. ACT ANN. art. 2.31 (West Supp. 1993) ("The powers of a corporation shall be exercised by or under the authority of, and the business and affairs of a corporation shall be managed under the direction of, a board of directors."). This pattern exists in both closely or publicly held corporations. Thus, as a matter of state law, directors are given control over day-to-day decisionmaking, although, as a practical matter, in publicly held corporations most of this control is delegated to officers who comprise the executive management of the company. *See* HARRY G. HENN & JOHN R. ALEXANDER, LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES §§ 223-226 (3d ed. 1983) (discussing officers' express and implied powers).

9. Outside directors, sometimes referred to as unaffiliated directors, are persons having no other paid position with the corporation. They cannot be executive officers or employees of the corporation. *See* HENN & ALEXANDER, *supra* note 8, § 204 (stating that outside directors must be non-officers). The American Law Institute's (ALI) proposed final draft of its *Principles of Corporate Governance* sets forth a more rigorous and detailed definition of outside directors. ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.34 (Proposed Final Draft, Mar. 31, 1992) [hereinafter ALI, CORPORATE GOVERNANCE] (discussing "significant relationship" between outside directors and corporations).

10. *See* HENN & ALEXANDER, *supra* note 8, § 204 (stating that most boards are two-thirds outsiders and one-third insiders).

11. HENN & ALEXANDER, *supra* note 8, § 219.

to which they are likely to be cooperative and receptive to management decisions.[12] Because these patterns are so prevalent, it is possible to address them as generalities, rather than by examining particular structures established by individual corporations. If the current patterns, including management[13] dominance and shareholder passivity, are not inevitable, and in fact have caused or contributed to significant problems, we should explore the possibility of modifying our regulatory regime to permit changes in the structure of corporate governance. Although the SEC designed the recent proxy amendments[14] to permit increased shareholder communication and to protect shareholder voting rights, they are no more than small steps in the right direction.[15]

The changes that this Article advocates are designed to permit large shareholders a more active role in corporate governance. The potential benefits of increased shareholder participation are based primarily on practical concerns, but a theoretical basis for adjusting the rules affecting the structure of corporate governance also exists.[16] This Article considers both practical and theoretical advantages to restructuring corporate governance models.

Part I provides a historical overview of shareholders and their role in corporate governance in the United States. It describes the evolving system of regulation affecting shareholders and management and analyzes how the existing regulatory structure affects shareholder participation in corporation governance.

Part II analyzes some of the problems that American corporations have experienced due to the current approach to corporate governance. The principal focus is on problems that have an economic impact on American corporations and on the shareholders of those

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12. *See infra* notes 376-77 and accompanying text.

13. Many commentators appear to use the terms "management" and "directors" interchangeably because management dominates most boards. Technically speaking, management of most companies is comprised of senior officers and corporate executives, most of whom are not directors. *See* HENN & ALEXANDER, *supra* note 8, § 223 (discussing general management functions of corporate officers). The company's chief executive officer, however, is almost always responsible for the structure and activities of the board of directors, and for the general structure of management operations as well. *See* HENN & ALEXANDER, *supra* note 8, § 225. For that reason, it often makes sense to think of directors and management in American companies as representing identical interests and sharing the same perspective.

14. 17 C.F.R. §§ 240.14a-1 to b-2 (1993).

15. The recent proxy amendments alleviate a few of the more oppressive restrictions with regard to a public shareholder's access to information and ability to communicate with other shareholders, but leave in place a large number of legal rules that preclude meaningful shareholder participation in corporate governance.

16. *See infra* part III.A.2. (contending that shareholders are owners of corporation and therefore ought to have role in corporate governance according to theoretical notions of democracy).

corporations.

Part III examines two related issues: whether permitting shareholders a greater role in corporate decisionmaking would produce any real benefits; and whether sufficient numbers of shareholders have the capability and the inclination to participate more actively in corporate decisionmaking if regulations were modified to permit such participation. This section also addresses some of the more common objections to permitting shareholders a greater voice.

Finally, Part IV discusses various ways to revise existing regulations to permit greater shareholder participation in corporate governance. Specifically, this Article proposes changes that would give shareholders the power to nominate directors, create a level playing field for shareholder proposals, institute confidential proxy voting, and provide shareholders with access to shareholder lists.

I. HISTORICAL OVERVIEW OF CORPORATE GOVERNANCE IN AMERICA

A. *Growth of Corporations and Shareholder Passivity*

At the turn of the century, corporations became increasingly prevalent and increasingly wealthy.[17] In turn, these corporations were owned by increasing numbers of shareholders, more than ninety percent of whom were individuals and many of whom came from the middle class.[18] These trends continued during the first three decades of this century.[19]

The most influential book documenting these trends and discussing the ramifications of corporate growth was Berle and Means' *The Modern Corporation and Private Property*.[20] Their statistical data demonstrated both the growth of corporations and the increasing

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17. *Cf.* RAYMOND W. GOLDSMITH, FINANCIAL INTERMEDIARIES IN THE AMERICAN ECONOMY SINCE 1900, at 56-87 (1958) (outlining growth of financial intermediaries between 1850 and 1952 as example of growth of corporations generally during same time period).

18. *See* GOLDSMITH, *supra* note 17, at 60. As subsequent sections of this Article discuss, the percentage of individual owners declined slowly over the next few decades. *Id. But see* Michael Siconolfi, *Individual Investors' Holdings of U.S. Stocks Fall Below 50% of Total Market for the First Time*, WALL ST. J., Nov. 13, 1992, at C1 (estimating that individuals accounted for 84% of stock ownership in 1965). In more recent years, the rate of change increased. In 1980, individual share ownership accounted for approximately 70% of equity interests in American companies. *Id.* Today, individuals account for less than 50% of equity interests in U.S. companies. *Id.*

19. *See* GOLDSMITH, *supra* note 17, at 56-87.

20. ADOLPH BERLE & GARDNER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1968). The book was the product of a collaboration that started in 1928, when Adolf Berle, Jr., was appointed research director of a project funded by the Social Science Research Council of America to investigate the impact of corporations on American society. Gardner C. Means was hired to conduct a careful statistical analysis of the growth of large corporations. *See* Robert Hessen, *The Modern Corporation and Private Property: A Reappraisal*, 26 J.L. & ECON. 273, 274 (1983) (summarizing history behind Berle and Means' collaboration).

dispersion of stock ownership in American corporations. Between 1909 and 1929, the value of assets held by non-financial corporations increased from approximately $63 billion to $131.5 billion.[21] Between 1900 and 1928, at the same time that corporations were growing at an exponential rate, the number of people owning corporate stock increased almost fourfold.[22] The number of small[23] shareholders also increased dramatically.[24]

Relying on these statistical trends, Berle and Means reached a number of conclusions. Their most influential conclusion was that large corporations would almost inevitably experience a separation of ownership from control.[25] Berle and Means then concluded that, given this separation of ownership and control, the existing structure of regulation affecting corporate governance was not satisfactory.[26] Berle and Means perceived the problem that shareholders had accepted ownership of stock while giving up one of the traditional indices of ownership—the right to control their property.[27] Shareholders had agreed to become passive owners.[28] Berle and Means believed that this passive ownership would lead to inefficient use of the property.[29] Economic theory justifies Berle and Means' fears. Where the owners of an enterprise manage that enterprise, they have

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21. BERLE & MEANS, *supra* note 20, at 36 tbl. III.

22. *See* BERLE & MEANS, *supra* note 20, at 52 tbl. VIII (showing that number of U.S. stockholders increased from 4.4 million to 18 million).

23. In this context, "small" refers both to the size of the economic investment by the shareholder and the total economic wealth controlled by the shareholder. Small shareholders owned a relatively insignificant fraction of the total shares of any corporation, and came from the middle rather than the upper classes. *See* BERLE & MEANS, *supra* note 20, at 59-60 (showing distribution of stock ownership by income bracket).

24. *See* BERLE & MEANS, *supra* note 20, at 59-60 (showing that, in 1929, corporations paid approximately 26% of all corporate dividends to individuals earning less than $5000 in taxable income per year, and approximately 51% of corporate dividends to persons with annual taxable incomes under $25,000 per year).

25. *See* BERLE & MEANS, *supra* note 20, at 6-7. Berle and Means viewed the separation of control as a virtual prerequisite to the growth of large corporations. While they conceded that it was possible to have exceedingly large corporations controlled privately, families or private groups having "personal wealth . . . sufficient to finance great enterprises, are so few, that they only emphasize the dependance of the large enterprise on the wealth of more than the individual or group of individuals who may be in control." *Id.* at 6.

Berle and Means actually characterized these firms as quasi-public corporations, apparently to distinguish them from corporations that were "public" in the sense of being operated by a governmental entity. *Id.* For the purposes of this Article, the phrase "public corporation" will be used as it is generally understood today—as short hand for a publicly owned corporation.

26. *See* BERLE & MEANS, *supra* note 20, at 10 (observing that existing corporate structure and trends must be examined closely to understand structure needed for future).

27. BERLE & MEANS, *supra* note 20, at 304.

28. BERLE & MEANS, *supra* note 20, at 304 (concluding that equity interests in large corporations were "passive property").

29. *See* BERLE & MEANS, *supra* note 20, at 115-16 & n.1 (citing pervasive mismanagement of various railroads between 1900 and 1915 as evidence that management, left to its own devices, would choose personal profit even at cost of bankrupting corporation).

the classic profit motive to encourage efficient behavior; if they are not efficient, they do not prosper. If owners are separate from managers, and the managers have effective control, there is less economic incentive to be efficient because profits are turned over to the owners rather than retained by those in control.[30]

The business community quickly accepted Berle and Means' vision of corporate America as an accurate description of the way corporate shareholders and directors interacted.[31] The community viewed shareholders as passive, and directors as separate and distinct from owners.[32] The statistical evidence amassed by Berle and Means was quite persuasive, and in the 1920s and 1930s, it was difficult to argue that the typical shareholder in a large American corporation had much to do with controlling or managing the corporation.[33]

B. *Regulation of Corporations and Directors—Barriers to Shareholder Participation in Corporate Governance*

Berle and Means' study prompted reexamination of the regulations affecting corporate governance structures. Legislatures and courts could have responded to the trends Berle and Means documented by treating corporate officers and directors as trustees acting for the benefit of shareholders.[34] While this change might have alleviated the concern that directors, as distinct and separate from shareholders, did not have a sufficient economic stake in making efficient management decisions, the model of directors as trustees per se was never adopted.[35] Instead, the law attempted to institutionalize the ideal of

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30. *See* BERLE & MEANS, *supra* note 20, at 307-08 (applying Adam Smith's profit-motive theories to corporations).

31. *See, e.g.*, Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Contractarians*, 65 WASH. L. REV. 1, 23 (1990); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 894; Elliott Goldstein, *Future Articulation of Corporation Law*, 39 BUS. LAW. 1541, 1543-44 (1984).

32. *See, e.g.*, Stephen M. Bambridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1058 n.126 (1993) (stating that this is "world of passive shareholders"); William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH. L. REV. 898, 912-13 (1993) (recognizing passivity of shareholders); Aleta G. Estreicher, *Beyond Agency Costs: Managing the Corporation for the Long Term*, 45 RUTGERS L. REV. 513, 519 (1993) (noting that corporate managers dominate shareholders).

33. *See* BERLE & MEANS, *supra* note 20, at 246 (describing weak position of shareholders, especially common shareholders). Of course, founding shareholders often retained vestiges of control even in very large public corporations by virtue of having entrenched themselves or those loyal to them in management positions.

34. *See* BERLE & MEANS, *supra* note 20, at 219-43 (discussing pros and cons of treating corporate officers and directors as trustees of shareholders).

35. *See* Hessen, *supra* note 20, at 278 (stating that ideal of directors as trustees roused little support because it required close judicial supervision). In theory at least, it is true that directors are fiduciaries for the shareholders or for the corporation, but the actual nature of directoral duties has been so watered down that no one seriously contends that directors are held to the

corporate democracy and to give more active control to shareholders.[36] Underlying this attempt was the belief that shareholders did not participate in corporate management because it was difficult for them to do so, and if corporations made shareholder participation easier, shareholder behavior might change.[37]

Based on the notion that shareholders needed better and more information in order to assume some degree of effective control over corporations,[38] Congress enacted the Securities Act of 1933[39] and the Securities Exchange Act of 1934.[40] The 1933 Act, which requires full disclosure of facts relating to the sale or purchase of securities, aims at allowing shareholders to make informed investment decisions.[41] Unlike the 1933 Act, which focuses on disclosures in the context of issuing and selling securities, the 1934 Act imposes continuing disclosure obligations once a corporation has acquired a group of public owners.[42] Specifically, the 1934 Act authorizes the Securities and Exchange Commission (SEC) to adopt regulations governing proxies and proxy solicitation.[43] For very practical

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utmost standard of care that typifies real fiduciary relationships. *See, e.g.*, Louisiana World Exposition v. Federal Ins. Co., 864 F.2d 1147, 1151 (5th Cir. 1989) (concluding that directors, though fiduciaries, may be held liable to stockholders only for gross negligence); Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (identifying corporate directors as fiduciaries, but concluding that gross negligence is proper standard for judging their behavior); Aronson v. Lewis, 473 A.2d 805, 812 & n.6 (Del. 1984) (holding that corporate directors, as fiduciaries, should be held to standards of gross negligence).

36. *See* Hessen, *supra* note 20, at 278 (contending that idea of returning control to stockholders is more popular than holding directors up as trustees).

37. Hessen, *supra* note 20, at 278-79.

38. *See* BERLE & MEANS, *supra* note 20, at 253 (asserting that their original text "became the foundation for the Federal legislation begun in 1933 and further developed later"); George J. Stigler & Claire Friedland, *The Literature of Economics: The Case of Berle and Means*, 26 J.L. & ECON. 237, 243-44 (1983) (asserting that *The Modern Corporation* was powerful influence on passage of Securities Exchange Act of 1933).

39. Securities Act of 1933, ch. 38, 48 Stat. 74 (1933).

40. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934).

41. 15 U.S.C. § 77(a) (1988).

42. For example, § 13(a) of the 1934 Act requires every issuer of a security registered on an exchange to file with the exchange and the Securities and Exchange Commission (SEC) information that the SEC, by rule, designates as necessary to keep the information filed in the registration statements "reasonably current," and to submit any annual and quarterly reports the SEC prescribes. 15 U.S.C. § 78m (1988). The SEC, through Rule 13a-1, normally requires corporations to file annual reports within 120 days after the close of the corporation's fiscal year. 17 C.F.R. § 240.13a-1 (1992). The basic annual report form is Form 10-K, although the Commission also requires corporations to submit copies of any annual report provided to shareholders. *See* 17 C.F.R. § 249.310 (1992). Rule 13a-11 also imposes current reporting requirements on most issuers whenever certain specified events occur. 17 C.F.R. § 240.13a-11 (1992).

43. 15 U.S.C. § 78n (1988). The federal proxy rules, 17 C.F.R. § 240 (1992), are those regulations promulgated by the SEC relating to shareholder voting under the authority of § 14(a) of the Securities Exchange Act of 1934. Section 14(a) of the 1934 Act provides:

> It shall be unlawful for any person . . . in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate . . . to solicit or to permit

reasons, these regulations have a significant impact on corporate governance. With wide dispersion of share ownership,[44] expecting shareholders to attend shareholder meetings in person becomes impractical. State law, however, requires a minimum percentage of shareholders to attend these meetings before the corporation can legally conduct business at a shareholder meeting.[45] As a practical matter, the only way to achieve a quorum is to solicit proxies from shareholders unable to attend but willing to cede their voting authority to others.[46] Shareholders who send proxies are counted as present for quorum purposes.[47] Proxy regulation, therefore, affects how virtually all shareholder votes in publicly held corporations are conducted.

The proxy rules adopted under the auspices of the 1934 Act did not, however, change the fact that corporate directors controlled American corporations, often to the exclusion of corporate shareholders. The proxy rules assume that those in control of the corporation (management, through the board of directors) will administer the proxy solicitation.[48] The rules are designed to encourage communication only by the group controlling the corporation or a group seeking total control.[49] Because the typical shareholder fits neither

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> the use of his name to solicit any proxy or consent or authorization in respect of any security . . . registered pursuant to section 12 of this title.

15 U.S.C. § 78n.

It is widely understood that most shareholders in public corporations participate in shareholders' meetings only via proxy, and not by attending the meetings in person. Regulations governing proxies thus potentially affect all communications designed to educate shareholders about matters submitted for shareholder approval, or to induce them to vote one way or the other on such proposals. 17 C.F.R. § 240.14a (1992).

44. Proposed Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, Exchange Act Release No. 19,135 [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,262 (Oct. 12, 1982).

45. *See, e.g.*, CAL. CORP. CODE § 602 (West 1990) (stating that, generally, business may not be transacted at shareholder meeting in absence of quorum); DEL. CODE ANN. tit. 8, § 216 (1991) (mandating that at minimum one-third of shares entitled to vote be present or represented at shareholder meeting for corporation to conduct business); N.Y. BUS. CORP. LAW 1 § 608 (McKinney 1986) (stating that majority of shareholders must be present or represented to transact business at shareholder meeting); TEX. BUS. CORP. ACT ANN. art. 2.28 (West Supp. 1993) (requiring that at least one-third of shares entitled to vote be present or represented for quorum to be present and for business to be conducted at shareholder meeting).

46. *Cf.* CAL. CORP. CODE § 602; DEL. CODE ANN. tit. 8, § 216; TEX. BUS. CORP. ACT ANN. art. 2.28.

47. *See, e.g.*, CAL. CORP. CODE § 602 (stating that majority of shares represented in person or by proxy constitute quorum); DEL. CODE ANN. tit. 8, § 216 (including shareholders represented by proxy in quorum); N.Y. BUS. CORP. LAW § 616 (McKinney 1986) (counting shareholders represented by proxy toward quorum); TEX. BUS. CORP. ACT ANN. art. 2.28 (permitting shareholders to be represented by proxy).

48. HARRY G. HENN, CORPORATIONS 461-64 (1961) (explaining proxy solicitation process).

49. *Cf.* 17 C.F.R. § 240-14a-2 (1993) (providing rules regarding proxy solicitation under stated circumstances).

of these descriptions, the proxy rules do not seem well-designed to foster communication and coordination among shareholders.

The proxy rules, originally adopted by the SEC soon after the passage of the 1934 Act,[50] were intended to institutionalize the ideal of corporate democracy and to help return some measure of control to shareholders.[51] The rules, however, were unsuccessful in rousing shareholders from their passivity. The rules, which permit shareholders to elect corporate directors,[52] mandate comprehensive disclosure before corporations can solicit proxies relating to the election of directors.[53] These disclosure obligations, while effective at stemming some of the more egregious abuses of power, were and are clearly insufficient to change the balance of power between management and shareholders. In public corporations, the outgoing board nominates candidates for the succeeding year's board of directors.[54] Shareholders have the right to elect a given slate of directors, but unless another party has initiated a proxy fight, where shareholders can choose between two opposing slates, shareholders have no meaningful options in electing directors. Under the federal proxy rules, shareholders have no meaningful way to nominate or elect different candidates.[55]

State law does not redress this imbalance of power. State corporate statutes give corporate directors the legal authority to manage the affairs of the corporation,[56] a right that presumably includes the

50. The SEC adopted rules LA1-LA7 on September 24, 1935, in Securities Exchange Act Release No. 378. The SEC promulgated regulation X-14, consisting of Rules X-14A-1 to X-14A-9, on August 11, 1938, in Securities Act Release No. 1823. Rules LA1-LA7 were rescinded.

51. *See* H.R. REP. NO. 1383, 73d Cong., 2d Sess. 15-16 (1934) (concluding that 1934 Act provisions relating to proxies were intended to permit SEC to act "with a view to preventing the recurrence of abuses which have frustrated the free exercise of the voting rights of stockholders"). Courts have concurred with this statement of intent and have allowed the SEC to act "to require fair opportunity for the operation of corporate suffrage." SEC v. Transamerica Corp., 163 F.2d 511, 518 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948); *accord* J.I. Case Co. v. Borak, 377 U.S. 426, 431-32 (1964) (finding that "fair corporate suffrage" is important right that should be provided to shareholders).

52. 17 C.F.R. § 240.14a-4(b)(2) (1992).

53. 17 C.F.R. §§ 240.14a-4(a), 240.14(b) (1992).

54. *See* HENN & ALEXANDER, *supra* note 8, § 205 (stating that shareholders only have right to *elect*, not to nominate, new directors).

55. The proxy rules specifically require that corporations give shareholders the authority to cast votes for write-in candidates, but because of the proxy rules themselves, shareholders could not communicate to coordinate a write-in campaign, thus effectively eliminating the usefulness of the write-in option. *See* 17 C.F.R. § 240.14a-4(b)(2)(iii) (1992).

56. *See* ALI, CORPORATE GOVERNANCE, *supra* note 9, § 3.01 (suggesting that although directors have broad corporate powers, they should appoint and supervise senior executives to oversee daily corporate operations). The comments to these ALI provisions acknowledge that most state statutes give the power to manage to directors, and may or may not expressly permit directors to delegate these powers, which include the right to nominate successors. *Id.* § 3.01 cmt. a. In reality, these distinctions appear irrelevant because public corporations do indeed

right to nominate successors. State statutes give shareholders the power to elect, but not nominate, directors,[57] and most allow corporations to give shareholders the right to remove directors for cause,[58] although courts have not always construed "cause" broadly.[59] As a practical matter, however, shareholders without access to the corporate proxy machinery stand very little chance of waging a successful campaign for removal of directors, especially over management opposition. Even when directors are removed, their successors are nominated by the remaining directors, *not* the shareholders.[60]

In addition to specific voting rights, state law, at least in theory,

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operate mostly through senior officers, the vast majority of whom are not themselves directors. It is widespread practice for senior executives, most notably the chief executive officer, to manage public corporations regardless of whether the state statutes expressly permit delegation of authority. *Id.* § 3.02 cmt. a ("Directoral management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies.") (citing Francis v. United Jersey Bank, 432 A.2d 814, 822 (N.J. 1981)).

57. *E.g.*, CAL. CORP. CODE § 301 (1990); DEL. CODE ANN. tit. 8, § 271 (1991); N.Y. BUS. CORP. LAW § 602(b) (McKinney 1986); *see also* HENN & ALEXANDER, *supra* note 8, § 188 (stating that shareholder participation usually is limited to electing or removing directors).

Other statutory provisions give shareholders additional voting powers, but these are very limited. *See* HENN & ALEXANDER, *supra* note 8, § 188 (explaining that "in the broader sense of participation in control, shareholders have limited management functions"). For example, most state statutes give shareholders the statutory right to vote for major changes to the corporation's structure. *See, e.g.*, DEL. CODE ANN. tit. 8, § 279 (1991) (requiring shareholder approval for sale, lease, or exchange of corporate assets); N.Y. BUS. CORP. LAW § 903(a)(2) (McKinney 1986) (permitting shareholders to vote on mergers); N.Y. BUS. CORP. LAW § 909(a)(3) (McKinney 1986) (permitting shareholders to vote on sale, lease, or exchange of corporate assets). This right typically includes the right to vote on such matters as mergers, recapitalizations, reorganizations, and sales of all or substantially all of the corporation's assets. *See* HENN & ALEXANDER, *supra* note 8, §§ 340-341. State statutes generally require shareholder approval for any of these transactions, although the particular vote required varies from jurisdiction to jurisdiction, and can be further modified by special provision in the articles of incorporation. *See id.* §§ 340-351.

Shareholders are also typically given the right to vote for changes that would require an amendment to the corporation's articles of incorporation. *See id.* § 340. It is possible in a very few instances for directors to amend articles without specific shareholder approval. If shareholders approve a provision in the articles authorizing "blank check" stock, the directors can amend the articles at a future date, specifying such rights, privileges, and other characteristics as the directors may determine without additional shareholder approval. *See, e.g.*, DEL. CODE ANN. tit. 8, § 151(a) (1991) (authorizing blank-check shares); TEX. BUS. CORP. ACT ANN. art. 2.13(B) (West Supp. 1993) (authorizing adoption of blank-check shares). Aside from these very limited situations, however, control over public corporations is firmly vested in the hands of the board of directors.

58. *E.g.*, DEL. CODE ANN. tit. 8, § 141(k) (1991) (permitting shareholders to remove directors with or without cause); CAL. CORP. CODE § 304 (West 1990) (permitting shareholders to remove directors for fraud, dishonesty, or abuse of position); N.Y. BUS. CORP. LAW § 706(a) (McKinney 1986) (permitting removal of directors with or without cause); *see also* HENN & ALEXANDER, *supra* note 8, § 192; *cf.* HENRY W. BALLANTINE, BALLANTINE ON CORPORATIONS 434 (rev. ed. 1946) (arguing that rule was "unsound" because it denied shareholder/owners right to remove directors even if they proved to be "entirely unsatisfactory").

59. *See, e.g.*, Leff v. C.I.P. Corp., 540 F. Supp. 857, 865-66 (S.D. Ohio 1982) (holding that harm to plaintiff shareholders must directly result from director misconduct for shareholder to meet cause requirement).

60. *See* HENN & ALEXANDER, *supra* note 8, § 205.

gives shareholders the right to sue to challenge actions taken by the board of directors.[61] Again, as a practical matter, the courts were, and continue to be, extremely reluctant to second-guess corporate decisions.[62] Because of this reluctance, legal doctrines protecting directoral decisions in all but the most egregious circumstances have developed such that the standards for prevailing against a director are almost impossibly high.[63]

1. *Trends and recent developments entrenching directoral control over corporate governance*

As the years passed, patterns of regulation remained relatively constant. Of course there have been new developments at both the state and federal levels, but for the most part these have not been effective in giving shareholders a greater role in corporate decisionmaking. In fact, many of the historical developments have made it more difficult for shareholders to participate in corporate governance. In particular, the SEC has changed the definition of "solicitation" several times, with the gradual effect of further limiting shareholder communications.[64]

The definition of solicitation is important because the proxy rules requiring advance notice to the SEC and extensive disclosure apply to anyone engaged in proxy solicitation.[65] Originally, the SEC limited the definition of solicitation to any proxy request.[66] The first regulatory amendments broadened the definition to include all communications from the person soliciting the proxy.[67] The next change occurred when the SEC expanded the definition of solicitation to cover "any request to revoke or not execute a proxy."[68] The SEC then determined that solicitation included "any communication" by a shareholder that could be "reasonably calculated" to influence

61. *See* HENN & ALEXANDER, *supra* note 8, § 192 (noting that shareholders may sue directly or on behalf of corporation).

62. *E.g.*, Consumer Power Co. Derivative Litig., 132 F.R.D. 455, 483 (E.D. Mich. 1990) ("[C]ourts are not to second-guess the corporate decision maker's choice . . . and substitute their own."); *see also* Hessen, *supra* note 20, at 278.

63. *See infra* notes 75-83 and accompanying text (showing that directors' standard of care is gross negligence, and in few recent cases challenged action was required to be *ultra vires*, or tainted by fraud).

64. "Solicitation" is currently defined as "any request to execute, or to revoke, a proxy; or the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." 17 C.F.R. § 240.14a-1(k)(1) (1992).

65. 17 C.F.R. § 240.14a-2 (1993).

66. Exchange Act Release No. 378 (Sept. 24, 1935).

67. Exchange Act Release No. 2376, 5 Fed. Reg. 174 (1940).

68. Exchange Act Release No. 3347, 7 Fed. Reg. 10,653 (1942).

any other shareholder to give, deny, or revoke a proxy.[69] These amendments made it increasingly difficult for shareholders to communicate with one another about upcoming votes; shareholders feared that even informal comments might later be construed as a "solicitation" and thus subject them to liability for failure to comply with the proxy rules.[70]

Changes in state law have also tended to entrench directors in positions of virtually absolute power. One of the most obvious examples is the extent to which state laws have indemnified directors or exempted them from liability for breaches of duty owed to the corporation. Historically, common law appeared to be divided on the issue of whether to permit a director to receive indemnification from liabilities arising out of actions taken in the course of corporate business.[71] Over time, however, all fifty states enacted statutes specifically authorizing indemnification of corporate directors.[72] As to limitations of liability, the trend is of even more recent vintage. Since 1985, forty-two states have adopted statutory provisions addressing directoral liability, most of which permit corporations to adopt charter provisions limiting directors' liability for monetary damages.[73] This trend represents a striking change from earlier law, which did not permit such broad limitations of directors' liability.[74]

Perhaps the most significant example of how state law has evolved over time to insulate directors more and more effectively is the business judgment rule. The business judgment rule, which can be

69. Exchange Act Release No. 5276, 21 Fed. Reg. 578 (1956).

70. *Cf.* Long Island Lighting Co. v. Barbash, 779 F.2d 793, 795-96 (2d Cir. 1985) (concluding that communications appearing in general-circulation publications can constitute solicitation if reasonably calculated to influence shareholders' votes); SEC v. Okin, 132 F.2d 784, 786 (2d Cir. 1943) (holding that preliminary communications may be deemed solicitations even if they do not request that recipient give, withhold, or revoke proxy).

71. *Compare* New York Dock Co. v. McCollom, 16 N.Y.S.2d 844, 848-49 (Sup. Ct. 1939) (holding indemnification not justifiable because liability is inherent risk in directorships) *and* Griesse v. Lang, 175 N.E. 222, 223 (Ohio 1931) (finding indemnification not permitted in absence of benefit to corporation) *with In re* E.C. Warner Co., 45 N.W.2d 388, 393-94 (Minn. 1950) (holding that directors were entitled to indemnification and finding stockholders failed in derivative suit) *and* Solimine v. Hollander, 19 A.2d 344, 348 (N.J. Ch. 1941) (upholding indemnification and allowing corporate directors to prevail in stockholder derivative suit).

72. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145 (1974); *see also* JOSEPH W. BISHOP, THE LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE ¶ 6.02, at 6-4-5 (1981 & Supp. 1988).

73. *E.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (1991) (limiting directors' personal liability for damages stemming from breach of fiduciary duty); *see also* DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 40, 42-47 nn.73-95 (3d ed. 1989) (listing and discussing such provisions).

74. *See* Theodore D. Moskowitz & Walter A. Effross, *Turning Back the Tide of Director and Officer Liability*, 23 SETON HALL L. REV. 897, 902-06 (1993) (discussing trend of increasing statutory limits on director and officer liability).

traced back at least 150 years,[75] apparently began as a presumption of regularity. Early cases tended to exonerate directors from liability for ordinary "mistakes"[76] and refused to impose on directors the duty of utmost care,[77] choosing instead to impose the same degree of care that ordinarily prudent persons would exercise.[78] At least one hornbook described this conception of the business judgment rule as the majority view.[79] Although "occasional opinions" declared that directors were not liable except for "gross negligence,"[80] this view was deplored as too lenient and was dismissed as the minority position.[81] Today, the majority rule retains the business judgment rule as a presumption of validity, but has adopted gross negligence as the principal standard of liability.[82] At least one court has adopted an even more stringent test for liability, requiring that the challenged action be *ultra vires* or tainted by fraud.[83]

In addition to these trends showing the increased latitude directors have in controlling their corporations, recent developments, which

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75. The business judgment rule can be traced back at least to the 1829 Louisiana decision in Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829). The court in *Percy* held that a director will only be liable by failing to possess "ordinary knowledge," which the court defined as failing to exercise "common sense, and ordinary attention." *Id.* at 77-78.

76. *See, e.g.*, Casey v. Woodruff, 49 N.Y.S.2d 625, 642-43 (App. Div. 1944) ("Mistakes in the exercise of honest business judgment do not subject the directors to liability."); Hodges v. New England Screw Co., 3 R.I. 9, 18 (1853) (stating that directors will not be liable for "mistakes").

77. *See, e.g.*, Pollitz v. Wabash R.R., 100 N.E. 721, 723-24 (1912) (holding directors to standard of merely "honest and unselfish" decisionmaking).

78. *See, e.g.*, Briggs v. Spaulding, 141 U.S. 132, 152 (1891) (explaining that defendant directors are only bound to level of care "which ordinary and diligent men would exercise"); Otis & Co. v. Pennsylvania R.R., 61 F. Supp. 905, 910-11 (D. Pa. 1945) (requiring directors to exercise "care, skill, and diligence which the ordinary prudent man would exercise in similar circumstances"), *aff'd*, 155 F.2d 522 (3d Cir. 1946); Anderson v. Akers, 7 F. Supp. 924, 928 (W.D. Ky. 1934) ("It is . . . well-settled that, even in the absence of a statute . . . directors . . . are bound to exercise . . . the degree of care which a reasonably prudent . . . director would exercise."), *modified in* 86 F.2d 518 (6th Cir. 1936), *rev'd on other grounds*, 302 U.S. 643 (1937).

79. NORMAN D. LATTIN, LATTIN ON CORPORATIONS § 78, at 274 (2d ed. 1971).

80. *See* Spiegel v. Beacon Participants, Inc., 8 N.E.2d 895, 904 (Mass. 1937) ("If directors, acting in good faith, nevertheless act imprudently, they cannot ordinarily be held to personal responsibility for loss unless there is a 'clear and gross negligence' in their conduct."); Swentzel v. Penn Bank, 23 A. 405, 414 (Pa. 1892) (holding directors "only liable for fraud, or such gross negligence as amounts to fraud").

81. LATTIN, *supra* note 79, § 78, at 274 ("Any court taking such a view has a heart too tender for the hard-hearted business men who usually sit upon boards of directors.").

82. *See* Louisiana World Exposition v. Federal Ins. Co., 864 F.2d 1147, 1151 (5th Cir. 1989) (holding that proper standard in for-profit business is at least gross negligence); Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (concluding that gross negligence is proper standard by which to judge directors' behavior); Aronson v. Lewis, 473 A.2d 805, 812 & n.6 (Del. 1984) (stating that business judgment rule is predicated on concept of gross negligence). *But see* Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264, 274-75 (2d Cir. 1986) (requiring standard of "reasonable diligence," not gross negligence); *see also* BLOCK ET AL., *supra* note 73, at 36-40 (dismissing idea that corporate directors should only be liable for gross negligence).

83. Gearhart Indus. v. Smith Int'l, Inc., 741 F.2d 707, 721 (5th Cir. 1984) (refusing to impose liability under Texas law on noninterested corporate director unless challenged action was *ultra vires* or tainted by fraud).

are not part of any distinct trend, nonetheless exclude shareholders from participating in corporate governance. One of these innovations is the development of "blank-check" shares.[84] Blank-check shares are created when a corporation's certificate of incorporation[85] authorizes its board of directors to issue a class of shares having rights, designations, and preferences to be determined in the future by the board of directors.[86] Normally, shareholders must approve any class of shares having such differences before they are issued, but with blank-check shares, the board can decide on the rights, designations, and privileges without consulting the shareholders even if the original blank-check authorization was adopted for a purpose other than one for which it is ultimately used.[87]

Another modern innovation relates to limiting voting rights of large shareholders. Nonvoting stock is not new,[88] but until recently, no court had upheld the issuance of a class of shares that gives voting rights to shareholders that hold less than a specified percentage of outstanding shares, and denies voting rights to shareholders whose stock ownership exceeds that threshold.[89] This type of share obviously undermines shareholder voting rights.[90]

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84. *See* DEL. CODE ANN. tit. 8, § 151(a) (1991) (allowing shareholders in Delaware corporations to authorize directors to issue classes of stock that will have their voting powers, designations, preferences, and other special rights determined by board of directors at later date).

85. The articles of incorporation must authorize all corporate shares. *See* HENN & ALEXANDER, *supra* note 8, § 123.

86. HENN & ALEXANDER, *supra* note 8, § 123.

87. *See* Asarco Inc. v. Court, 611 F. Supp. 468, 476-77 (D.N.J. 1985) (holding that, generally, blank-check provision in corporate charter authorized board of directors to issue special class of shares as takeover defense, even though shareholders had voted in favor of blank-check provision pursuant to proxy solicitation that had addressed need for flexibility in capital structure to facilitate future acquisitions). The court in *Asarco* held, however, that, under the circumstances of the case, the directors could not issue the blank-check shares with the special terms proposed by the directors because to do so would destroy the equality of voting power between stockholders. *Id.*

88. In fact, the New York Stock Exchange (NYSE) has long been concerned with nonvoting shares and shares having multiple votes.

89. *See* Baker v. Providence and Worcester Co., 378 A.2d 121, 123 (Del. 1977).

The SEC attempted to prevent companies from taking steps to nullify, restrict, or disparately reduce the per share votes of existing shareholders by adopting Rule 19c-4. *See* Voting Rights Listing Standards—Disenfranchisement Rule, Exchange Act Release No. 34-25,891, 53 Fed. Reg. 26,376, 26,394 (1988) (codified at 17 C.F.R. § 240 19c-4 (1990)). The Business Roundtable successfully challenged the SEC's authority to promulgate this rule. Business Roundtable v. SEC, 905 F.2d 406, 407 (D.C. Cir. 1990) (holding that SEC had no authority to control substantive allocation of power among classes of shareholders). The NYSE and NASDAQ, however, voluntarily adopted the essence of Rule 19c-4, and the AMEX also took action to limit disenfranchisement of existing shareholders. *See* Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW. 1461, 1470-72 (1992). None of these actions, however, preclude the sale of new classes of shares with such restrictions.

90. One might wonder about the advantages of creating a class of shares that so obviously limits shareholder rights. One advantage is that such a class of shares is a powerful disincentive

In essence, state corporate statutes give shareholders very limited rights to participate in corporate management, and state courts have upheld creative strategies that encroach on even these limited rights. In addition, state courts generally have not permitted shareholders to assume greater responsibilities at the expense of directoral discretion.[91] In the rare instances where states have adopted rules allowing shareholders to assume greater roles in corporate governance, such provisions usually do not apply to public corporations.[92]

It is not true that all modern rules and regulations are designed to preclude shareholders from participating in corporate governance or that all trends in corporate law are aimed at achieving that result. Many existing regulations are intended to encourage shareholder participation. The federal proxy rules,[93] for example, provide two specific mechanisms whereby shareholders can communicate with one another. First, if a corporation conducts a proxy solicitation, as it must at least once a year, the regulations expressly require the corporation to assist any shareholder in communicating with other shareholders by way of a separate proxy solicitation.[94] Second, the regulations require the corporation to include shareholder proposals that meet certain requirements in its proxy materials.[95] Because the

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to a hostile takeover. A successful acquisition of more than the threshold percentage of such a class of shares would result in the acquiror holding such shares but being unable to vote them. In a takeover context, it is voting power that makes the shares valuable, and so this type of limitation on voting makes the issuance of this kind of share particularly suitable as an anti-takeover defense.

91. *See* Charleston Boot & Shoe Co. v. Dunsmore, 60 N.H. 85, 86-87 (1880) (refusing to impose liability on board of directors that negligently refused to follow recommendations from shareholder representative regarding proper disposition of corporate assets, at very substantial loss to corporation); *see also* HENN & ALEXANDER, *supra* note 8, § 267 (explaining that "[e]ven unanimous agreements which substantially impinge on the directors' discretion or other 'statutory norms' are invalid, in the absence of express statutory recognition"). Henn and Alexander recognize that although a few state statutes permit shareholders to restrict directors' discretion in closely held corporations, this remains the exception rather than the norm. HENN & ALEXANDER, *supra* note 8, § 267. Even where such shareholder agreements are permitted, for example, by inclusion of relevant provisions in the certificate of incorporation, liability is shifted from the directors to the shareholders. *See* DEL. CODE ANN. tit. 8, §§ 351(2)-(3) (1991); N.Y. BUS. CORP. LAW § 620(f) (McKinney 1986).

92. *See, e.g.*, N.Y. BUS. CORP. LAW § 620(b) (McKinney 1986) (allowing shareholders to assume responsibilities typically left to directors, so long as articles of incorporation clearly spell out this allowance, and noting that this is limited to corporations whose shares are not listed on national securities exchange or regularly traded in over-the-counter market); *see also* Zion v. Kurtz, 405 N.E.2d 681, 684 (N.Y. 1980) (holding that Delaware public policy did not proscribe shareholder agreement that took away management functions from directors in corporation with fewer than thirty shareholders).

93. 17 C.F.R. §§ 240.14a-1 to 14a-14 (1992).

94. 17 C.F.R. § 240.14a-7 (1992) (requiring corporation either to give shareholder "reasonably current list of the names and addresses of the holders of record" of voting stock, or to mail shareholder's proxy itself, at shareholder's expense).

95. 17 C.F.R. § 240.14a-8 (1992).

first alternative is so expensive,[96] it is typically used only by those seeking control by means of a proxy contest, and it generally is not used by shareholders who want only limited changes to existing management or policies.[97] The second alternative, the shareholder proposal, is used far more frequently.[98]

Even the shareholder proposal provision, however, is very limited. A corporation may safely exclude a number of types of proposals from its proxies.[99] The most significant of these exclusions relate to proposals that deal with "the conduct of the [corporation's] ordinary business operations,"[100] and proposals that relate "to an election to office."[101] Moreover, shareholders are limited to one proposal per meeting,[102] and that proposal may be accompanied only by a supporting statement of no more than 500 words.[103]

The most recent amendments to these rules were designed to increase shareholder communications and shareholder participation. In October 1992, the SEC adopted amendments to the federal proxy rules "designed to foster shareholder communication" and remove "unnecessary limitations on shareholders' use of their voting rights."[104] The SEC concluded that the prior proxy rules were contrary to Congress' intent to assure "fair, and effective shareholder suffrage."[105] The SEC declared that the amendments were necessary to remove "regulatory impediments to communication among shareholders and others and to the effective use of shareholder voting

96. Mark A. Stach, *An Overview of Legal and Tactical Considerations in Proxy Contests: The Primary Means of Effecting Fundamental Corporate Change in the 1990s*, 13 GEO. MASON U. L. REV. 745, 752 (1991).

97. *Id.* at 751-52.

98. *Id.* at 751 (stating that, because most proxy fights are expensive, they are generally used for gaining control of corporation, whereas shareholder proposals are used for expressing dissatisfaction with management).

99. *See* 17 C.F.R. § 240.14a-8(c) (1992) (allowing exclusion of proposals related to subjects not proper for shareholder action, to operations that account for less than five percent of corporation's total assets and less than five percent of its net earnings and is not otherwise significantly related to registrant's business, to conduct of ordinary business, to election to office, to shareholder attempts to oppose proposal to be submitted by corporation, and to other proposals that have been previously submitted and received fewer than certain specified percentages of shareholder votes); *see also infra* notes 122-29 and accompanying text (discussing these limitations and ability of management to exclude shareholder proposals).

100. 17 C.F.R. § 240.14a-8(c)(7) (1992).

101. *Id.* § 240.14a-8(c)(8).

102. *Id.* § 240.14a-8(a)(4).

103. *Id.* § 240.14a-8(b)(1).

104. Shareholder Communications and Executive Compensation, Exchange Act Release Nos. 33-6962 and 31-326, Fed. Sec. L. Rep. (CCH) ¶ 1525, pt. II (Oct. 21, 1992) [hereinafter Shareholder Communications]. The SEC adopted these rules following "an extensive three-year examination by the Commission of the effectiveness of the proxy-voting process and its effect on the corporate governance system . . . ." *Id.* at 7.

105. *Id.* at 7-8.

rights."[106] These amendments did not, however, remove any of the limitations imposed on shareholder proposals.

2. *Exclusion from the directoral nominating process*

The foregoing discussion indicates that developments in recent years have made it increasingly difficult for shareholders to participate in corporate governance. The single most significant obstacle, however, is the inability of shareholders to nominate directors.

Because management of the typical corporation is vested in its board of directors, the process by which directors are nominated is particularly important.[107] Obviously, the entire election process is important, but if directors are not nominated, they cannot be elected. Because management traditionally has controlled the nominating process, the fact that shareholders get the final vote is not nearly as significant as it might appear. Unfortunately, both state law and federal regulations have been drafted in such a way as to ignore the nomination process.

The federal proxy rules[108] provide mechanisms through which shareholders can initiate proposals for consideration by other shareholders.[109] The same regulations that obligate management

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106. *Id.* at 8. The text of the amendments is quite lengthy. The most important provisions relating to shareholder communications and shareholder voting, however, are relatively straightforward. Rule 14a-2(b) is amended to exempt from the proxy statement and disclosure requirements communications from most persons not seeking proxy authority and not having a substantial interest in the matter subject to a vote. 17 C.F.R. § 240.14a-2(b) (1992). Rule 14a-1 now permits shareholders to announce how they intend to vote without having to comply with the proxy rules. *Id.* § 240.14a-1(1). Under new Rule 14a-3, solicitations made via public broadcast, speech, or publication are exempt if a definitive proxy statement is already on file with the SEC. *Id.* § 240.14a-3(f). Preliminary proxy statements are now allowed under rules 14a-3(a) and 14a-4. *Id.* §§ 240.14a-3(a) and 240.14a-4. Finally, under Rule 14a-4(d), shareholders who seek minority representation on a board of directors may name one or more management nominees on their proxy, so long as the nominees consent. *Id.* § 240.14a-4(d).

107. The importance of nominating directors becomes immediately apparent when one reviews typical proxies solicited for annual meetings. For each position on the board of directors that needs to be filled, management will nominate one candidate. Because it takes only a plurality vote to elect directors, even withholding votes for a management candidate will not change the outcome. Nor are nominations from the floor a viable option; most shareholders will cast their votes in advance, by means of the very proxies that offer no meaningful choices.

108. 17 C.F.R. § 240 (1992).

109. *Id.* § 240.14a-8. There are, however, numerous requirements that a shareholder must meet before a corporation can be forced to include a shareholder proposal in its proxy materials. For example, the proponent must own at least one percent or $1000 in market value of voting securities for a period of not less than one year. *Id.* § 240.14a-8(a)(1). In addition, the shareholder must submit the proposal substantially in advance of the meeting, which in the case of annual meetings means at least 120 days before the corporation is expected to release its own proxy materials. *Id.* § 240.14a-8(a)(3). A shareholder is limited to one proposal, and the supporting statement may not exceed 500 words. *Id.* § 240.14a-8(a)(1)(4). Finally, the corporation need not include the proposal if it falls into any one of 12 categories identified by statute. *Id.* § 240.14a-8(c); *see also supra* note 99 (listing types of shareholder proposals that

to accept and disseminate shareholder proposals, however, expressly authorize management to exclude proposals relating to election to office.[110] While the SEC claims authority to regulate the nominating process,[111] it has not chosen to do so, and this default has allowed management to control nominations to the exclusion of potential shareholder candidates.

The longstanding corporate governance project of the American Law Institute (ALI) set out to evaluate existing regulations and rules on corporate governance issues.[112] One of the specific topics the project addressed was the directoral nominating process.[113] After more than a decade of discussion, the project proposed as a final recommendation that corporations form a nominating committee of outside directors[114] to recommend[115] directoral candidates to the board. The comments to this section make clear that this suggestion was not intended to prevent management from taking an active role in the nominating process.[116] The ALI remarked, "On the contrary, such persons, and in particular, the chief executive officer, can be expected to be highly active in recommending to and discussing candidates with the committee . . . ."[117] In fact, the ALI's proposed final draft seems little more than a codification of existing practice. Although existing law does not require the use of nominating committees, surveys of large public corporations indicate that such committees are widespread.[118] Thus, the ALI's proposed final draft

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corporation need not include in proxy materials).

110. 17 C.F.R. § 240.14a-8(c)(8).

111. Exchange Act Release No. 13,901, [1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,296 (Aug. 29, 1977).

112. *See* ALI, CORPORATE GOVERNANCE, *supra* note 9 (showing that first tentative draft of ALI project on corporate governance was finished in 1982, while proposed final draft was not complete until March 31, 1992).

113. ALI, CORPORATE GOVERNANCE, *supra* note 9, § 3A.04.

114. The proposed final draft does not use the term outside director. The draft actually suggests that the nominating committee be composed "exclusively of directors who are not officers or employees of the corporation, including at least a majority of members who have no significant relationship with the corporation's senior executives." ALI, CORPORATE GOVERNANCE, *supra* note 9, § 3A.04(a). In addition, "officers," "significant relationship," and "senior executives" are defined terms. *See* ALI, CORPORATE GOVERNANCE, *supra* note 9, at pt. I, Definitions, 1-68.

115. The use of the phrase "recommend to the board" may be quite significant. There is nothing in the ALI draft that requires the board to accept the nominating committee's recommendations, and nothing gives the committee any authority to interact directly with the shareholders. ALI, CORPORATE GOVERNANCE, *supra* note 9.

116. *See* ALI, CORPORATE GOVERNANCE, *supra* note 9, § 3A.04 cmts., at 160-64.

117. ALI, CORPORATE GOVERNANCE, *supra* note 9, § 3A.04 cmt. c, at 161.

118. The Reporter's notes to § 3A.04 indicate that the ALI was aware of these studies in the drafting process. ALI, CORPORATE GOVERNANCE, *supra* note 9, § 3A.04, reporter's notes. The Reporter cites two studies, HEIDRICK & STRUGGLES, THE CHANGING BOARD tbl. 11, at 13 and KORN & FERRY, BOARD OF DIRECTORS tbls. 4A, 4B, which report that approximately 60% of

offers no real hope for reapportioning control over the nomination process between directors and shareholders.[119]

3. *Other limits on shareholder proposals*

Of course, the inability of shareholders to assume a meaningful role in the nomination of directors is not the only significant result of the division of responsibility and power between shareholders and directors. As mentioned earlier, the federal proxy rules do provide mechanisms through which shareholders in public corporations can communicate with each other.[120] If a shareholder desires to make a proxy solicitation at the same time as the corporation is making such a solicitation, the corporation may be required to include in its proxy materials copies of proxy statements and proxies furnished by the shareholder, provided that the shareholder bears the cost of including such materials.[121] Alternatively, shareholders desiring to make proposals for consideration by other shareholders can force the corporation to include such proposals in the corporation's own proxy materials, but only if certain requirements are met.[122]

In fact, these requirements for shareholder proposals are quite restrictive. One of the most important restrictions on such proposals, discussed in the preceding section, is that they may not relate to elections to office.[123] This restriction is not the only significant limitation. Management can choose to exclude any shareholder proposals that are not "proper subjects of shareholder action."[124]

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responding corporations utilize nominating committees composed primarily of outside directors.

119. Participants in and observers of the ALI drafting process will not be surprised by this insight, given the active participation by the Business Roundtable in discouraging any significant reapportionment of power between management and shareholders.

120. *See supra* notes 93-95 and accompanying text (describing two ways federal proxy rules facilitate shareholder communication); *see also* 17 C.F.R. §§ 240.14a-7 to 14a-8 (1992) (dictating guidelines under which shareholders can make proxy solicitations to other shareholders or include proposal in corporation's proxy statement).

121. 17 C.F.R. § 240.14a-7. At the option of the corporation, the shareholder seeking to distribute proxy materials may be given a shareholder list and told to distribute the materials without further assistance from the corporation. *Id.* § 240.14a-7(c). Corporations, however, do not typically rely on this alternative, possibly because of a reluctance to provide current shareholder lists to dissidents. *See* LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 466-67 (2d ed. 1988) (stating that management prefers to mail proxy materials for shareholders while shareholders prefer access to mailing list in order to do personal solicitation).

122. 17 C.F.R. § 240.14a-8 (1992); *see also supra* note 99 and accompanying text (listing some limitations on content of shareholder proxy proposals).

123. 17 C.F.R. § 240.14a-8(c)(8) (1992).

124. *Id.* § 240.14a-8(c)(1). This power to exclude shareholder proposals is designed not to upset the allocation of power between shareholders and directors mandated by state law. *See* LOSS, *supra* note 121, at 473 (suggesting that state law is not sufficient guide because there is not much of it). Therefore, most shareholder proposals are cast in advisory terms. *See* Klaus Eppler & Karen B. Leibowitz, *Dealing with Rule 14a-8 Shareholder Proposals*, *in* PLI PROXY CONTESTS, INSTITUTIONAL INVESTOR INITIATIVES, MANAGEMENT RESPONSES 779, 788 (1990). In one sense,

Furthermore, shareholder proposals must relate to a significant aspect of the corporation's business;[125] they may not relate to dividends[126] or the ordinary business of the corporation.[127] Finally, shareholder proposals may not conflict with a management proposal.[128] The SEC has permitted management to exclude a wide variety of shareholder proposals on these grounds.[129]

In addition to these substantive limitations on shareholder proposals, other aspects of the requirements for shareholder proposals tip the balance in favor of management. Shareholders must

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this limitation does not prevent many shareholder proposals because shareholders can often circumvent the rule by careful phrasing. In another sense, however, this exclusionary rule is very powerful because it means that most shareholder proposals are no more than precatory in nature. Even a "successful" shareholder proposal might, therefore, have minimal impact; directors are not obligated to heed shareholder proposals in reaching a final decision on the issue.

125. 17 C.F.R. § 240.14a-8(c)(5) (1992). This regulation determines significance primarily in terms of whether the proposal relates to a matter that accounts for more than five percent of the corporation's business or assets, but also authorizes shareholder proposals that are otherwise significant even if they fail the financial interest threshold. *Id.*

126. *Id.* § 240.14a-8(c)(13). This provision reflects the traditional state law rule that directors have discretion in declaring and paying dividends. *E.g.*, VA. CODE ANN. § 13.1-653 (Michie 1993) (allocating authority to board of directors to declare and make distribution to shareholders).

127. 17 C.F.R. § 240.14a-8(c)(7) (1992).

128. *Id.* § 240.14a-8(c)(9).

129. *See* Eppler & Leibowitz, *supra* note 124, at 796 (discussing SEC no-action letters that allow exclusion of shareholder proxy proposals). The Commission has permitted exclusion of proposals limiting the number of officers, *e.g.*, The Procter & Gamble Co., SEC No-Action Letter, Wash. Serv. Bureau, No. 0610-85003 (May 30, 1985), proposals requiring directors to report negative votes, *e.g.*, Union Electric Co., SEC No-Action Letter, Wash. Serv. Bureau, No. 22486008 (Feb. 19, 1986), and proposals dealing with executive compensation and dedication of the budget to specific items such as advertising, *e.g.*, Carolina Power and Light, SEC No-Action Letter, Wash. Serv. Bureau, No. 040483023 (Mar. 25, 1983); Litton Industries, SEC No-Action Letter, Wash. Serv. Bureau, No. 102780049 (Sept. 9, 1980, reconsidered Oct. 29, 1980).

During the first four months of 1990, the Commission published approximately 320 no-action letters. Eppler & Leibowitz, *supra* note 124, at 802. Through these letters, the Commission excluded a wide variety of proposals relating to compensation issues. *See id.* at 828-29. *See also* Pinnacle West Capital Corp., SEC No-Action Letter, Wash. Serv. Bureau, No. 040290021 (Mar. 23, 1990) (excluding proposal that called for reduction of corporate salaries until dividend payments were resumed); UAL Corp., SEC No-Action Letter, Wash. Serv. Bureau, No. 030590020 (Feb. 23, 1990) (allowing exclusion of proposal to reduce directors' salaries and benefits). The Commission also excluded some resolutions condemning particular officers, directors, or the entire board, or asking for a vote of "no confidence." HealthVest, SEC No-Action Letter, Wash. Serv. Bureau, No. 040990029 (Apr. 4, 1990) (excluding proposal for no-confidence vote); Time-Warner Inc., SEC No-Action Letter, Wash. Serv. Bureau, No. 040290023 (Mar. 23, 1990) (permitting corporation to omit proposal for censure of directors who voted against acquisition offer); Exxon Corporation, SEC No-Action Letter, Wash. Serv. Bureau, No. 020590022 (Jan. 26, 1990) (excluding proposal to remove board of directors and CEO).

Although reported decisions in this area are rare, courts have upheld some of these exclusions. For example, in Grimes v. Ohio Edison Co., 992 F.2d 455, 457 (2d Cir. 1993), the court permitted a corporation to exclude a shareholder proposal that would have required approval of corporate capital expenditures in excess of a specified minimum. *Id.* The court allowed the corporation to exclude the proposal because it related to the ordinary business of the corporation. *Id.* at 458; *see also* Curtin v. American Tel. & Tel. Co., 124 F. Supp. 197, 197 (S.D.N.Y. 1954) (permitting corporation to exclude proposal because it related to pension rights and because proposal was offered by holder of only one share).

limit their proposals and any accompanying explanations to a combined total of 500 words,[130] while management can respond at length.[131] Moreover, management, unlike shareholders making proposals, has access to proxy cards as they are returned.[132] Because the vast majority of American corporations have steadfastly refused to respect the confidentiality of shareholder votes,[133] management often contacts shareholders prior to and even after submission of proxies.[134] Resolicitation of shareholders who vote against management wishes apparently is not uncommon.[135]

Until recently, shareholders could not even communicate with other shareholders about how they intended to vote on matters to be presented at upcoming shareholder meetings without complying with the extensive disclosure requirements of the federal proxy rules. In the latest round of amendments to the proxy rules, however, the SEC has exempted certain types of shareholder communications from the disclosure requirements. These include statements of how shareholders intend to vote on proposals to be considered at upcoming shareholder meetings[136] and communications by shareholders who are not seeking proxy authority.[137] The amended proxy rules do not, however, allow shareholders to seek proxy authority on any matters discussed in their communication, nor do they change most

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130. 17 C.F.R. § 240.14a-8(b)(1) (1992).

131. *See* LOSS, *supra* note 121, at 471 (stating that management is not limited to maximum number of words in reply).

132. *See infra* notes 492-95 and accompanying text (analyzing shareholder studies that indicate shareholders are increasingly contacted and pressured to vote in particular way).

133. A minority of American corporations have, however, recognized confidentiality of shareholder voting. For example, Alcoa, American Brands, American Telephone & Telegraph (AT&T), Chase Manhattan, Chemical Banking, Chevron, Citicorp, Datapoint, Du Pont, Exxon, General Electric, General Mills, General Motors, IBT, IT&T, Loral, Minnesota Mining & Manufacturing (3M), J.P. Morgan, Sara Lee, United Technologies, and Xerox were all included in a 1988 study on confidential voting conducted by the Investor Responsibility Research Center. PATRICK S. MCGURN, INVESTOR RESPONSIBILITY RESEARCH CTR., CONFIDENTIAL PROXY VOTING 39 (1989).

134. The Investor Responsibility Research Center (IRRC) conducts regular annual surveys of institutional investors. In response to the IRRC's 1988 survey, more than three out of four respondents indicated that management representatives had contacted them to discuss pending proxy votes, and 14% of such shareholders indicated that they thought the contact that they had received was "improper." *Id.* at 64. In both 1986 and 1987, approximately two-thirds of all responding investors had indicated that such contact had occurred. *Id.*

135. While there are no precise figures on resolicitation, there is substantial evidence that it occurs. For example, resolicitation on the infant formula shareholder proposal at American Home Products was apparently the impetus for repeated shareholder proposals seeking confidential voting. *Id.* at 76. This incident also prompted the SEC to examine the issue of resolicitations. In its 1980 Staff Report on Corporate Accountability, the Commission indicated that resolicitation "may constitute an unfair use of management control over the corporate proxy machinery." *Id.* The SEC eventually declined to regulate such resolicitations.

136. 17 C.F.R. § 240.14a-1(l)(2)(iv) (1993).

137. *Id.* § 240.14a-2(b).

of the restrictions on the content and form of shareholder proposals. Taken as a whole, the system of regulation relating to shareholder proposals allows shareholders no more than a glimpse at what increased communication on important issues might accomplish.

In effect, the proxy rules are designed to allow shareholders some measure of freedom to communicate with each other and to make proposals for consideration at shareholder meetings. The current rules, however, fall short of creating a system where shareholders are permitted the same access to other shareholders that management enjoys.[138] Without a more level playing field between management and shareholders with regard to voting on corporate governance issues, and particularly with regard to the nomination of directors, it is unlikely that shareholders will be able to exercise proxy rights in a way that will operate as an effective check on abuses of power by management.

C. *The Modern Corporation*

The SEC not only structured the original proxy solicitation rules[139] with the Berle and Means' corporate paradigm in mind,[140] but also promulgated them at a time when that paradigm accurately reflected reality. The vast majority of American investors at the time were individuals,[141] and those individuals tended to be passive and relatively loyal to the companies in which they invested.[142] Shareholders typically lacked the expertise, resources, time, and motivation

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138. *Cf. infra* note 184 (explaining that exorbitant costs limit shareholder participation). While it is true that most shareholders not seeking proxy authority may now communicate with each other without complying with the extensive proxy solicitation rules and that management must comply with the proxy rules, management expenses are paid for by the corporation, and management can hire corporate counsel to insure compliance with the rules. *Cf.* LOSS, *supra* note 121, at 450 (suggesting that policy of paying management's proxy costs from corporate funds should be one of reasonableness and that corporation should not pay "unreasonable" expenses with corporate funds).

139. 17 C.F.R. §§ 240.14a-1 to 14a-12 (1992).

140. *See supra* notes 25-33 and accompanying text (describing Berle and Means' view of corporate America, which includes passive shareholders and division between directors and owners).

141. *See* GOLDSMITH, *supra* note 17, at 225 (observing that at turn of century individual holdings accounted for 92.4% of equity securities in this country). Institutional ownership of such securities increased from 7.6% in 1900 to over 20% by 1950. *Id.* According to the SEC, in 1952 individuals owned almost 75% of the outstanding stock in American companies. 1 SEC INSTITUTIONAL INVESTOR STUDY REPORT, H.R. DOC. NO. 64, 92d Cong., 1st Sess. 119 (1971).

142. Louis Lowenstein, *Beating the Wall Street Rule with a Stick and a Carrot*, 1988 ANN. REV. BANKING L. 251, 252 [hereinafter Lowenstein, *Stick & Carrot*] (estimating that annual turnover of stocks on New York Stock Exchange in 1960 was as low as 12%); Louis Lowenstein & Ira M. Millstein, *The American Corporation and the Institutional Investor: Are There Lessons From Abroad?*, 1988 COLUM. BUS. L. REV. 739, 743 (estimating 1960 turnover rate at 14%). At the time the SEC promulgated the proxy rules, the average daily trading volume on the New York Stock Exchange was three million shares. *Id.*

to become actively involved in the management of corporations in which they chose to invest.[143] They were willing to wait patiently for dividend checks, hoping for appreciation in share value, but willing to depend on others to manage the corporation in such a way as to produce that appreciation.[144]

This vision of corporate America is no longer accurate. Numerous commentators have noted the extraordinary shifts in patterns of stock ownership over the last few decades.[145] Institutional investors[146] now account for a substantial percentage of stock ownership in American companies,[147] owning approximately one-half of the

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143. *See* Daniel Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1276-77 (1982) (arguing that individual investors lack expertise and inclination to actively participate in corporate governance).

144. *Id.* The appreciation was a less important consideration because most shareholders tended to invest for the long term. A reliable income stream was often more important in deciding between investment options, and in fact, the dividend theory of stock valuation, which developed while this model of shareholder participation was prevalent, posits that dividend policy is the single largest determinant of share value. *See* BENJAMIN GRAHAM ET AL., SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES, 480-82 (4th ed. 1962) (discussing historical primacy of dividends in investment decisions).

145. *See, e.g.*, Allen D. Boyer, *Activist Shareholders, Corporate Directors, and Institutional Investment: Some Lessons From the Robber Barons*, 50 WASH. & LEE L. REV. 977, 977 (1993) (discussing shift of majority of corporate equity into institutional hands); Warren F. Grienenberger, *Institutional Shareholders and Corporate Governance*, *in* PLI PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS UNDER THE NEW PROXY RULES 593, 600 (1993) (attributing growth of ownership by institutional investors to growth of pension funds in large corporations and government); Lowenstein & Millstein, *supra* note 142, at 742 (reporting that assets controlled by institutional investors increased from about $2.1 trillion in 1981 to $4.46 trillion in 1987). In 1986, institutional investors owned 42.7% of the total outstanding stock in American companies. *Id.* at 743.

Congress is also aware of the shifting patterns of ownership. In 1986, the Committee on Energy and Commerce reported that "[w]hile direct holdings of stocks by individuals fell by $400 billion over the period from 1978 through 1985, . . . holdings by institutional investors rose by $221 billion." *Pension Funds in Capital Markets, 1986: Hearings on the Impact on Corporate Governance, Trading Activity and Beneficiaries Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 99th Cong., 2d Sess. 1 (1986) (opening comments of Rep. Wirth).

While more than 90% of all equity securities were in the hands of individual investors at the turn of the century, GOLDSMITH, *supra* note 17, at 225, the Securities Industry Association has estimated that individual share ownership today accounts for less than 50% of the total shares owned. Siconolfi, *supra* note 18, at C1. This percentage declined slowly at first, and has recently decreased more rapidly. *Id.* (noting 13.1% drop in individual ownership between 1965 and 1980 and 71% drop between 1980 and 1992).

146. The term "institutional investor" is generally defined to include pension funds, investment companies, life insurance companies, bank-managed trust funds, state and local retirement funds, foundations, education endowments, and similar funds. *See* Lowenstein & Millstein, *supra* note 142, at 742 (defining "institutional investor").

147. *See* Peter F. Drucker, *Reckoning with the Pension Fund Revolution*, 69 HARV. BUS. REV., Mar.-Apr. 1991, at 106, 106 (estimating that total institutional investor ownership accounts for nearly 40% of ownership of large and mid-size businesses). Other sources estimate that institutional ownership is even greater. On November 13, 1992, the Wall Street Journal reported that individual investors' holdings in U.S. stocks fell below one-half of the total market. Siconolfi, *supra* note 18, at C1. Furthermore, the economic importance of institutional investors is only likely to increase over the next few years. For each year during the 1990s, it is likely that pension plans alone will have between $100 and $200 billion to invest, and much of that is

outstanding stock in public companies.[148] The "typical" shareholder in this country is now an institutional investor, such as a pension plan.[149] This contrasts sharply with earlier patterns of stock ownership.

The shift in ownership and economic power has been accompanied by a significant decrease in the average holding period for stocks. This phenomenon is clearly demonstrated by comparing the stock turnover rates experienced in the early 1960s with current turnover rates.[150] In 1960, the rate of turnover for stocks traded on the New York Stock Exchange was between twelve and fourteen percent.[151] To rephrase this statistic, if 1000 investors had each purchased one

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expected to be placed in the equity markets. Drucker, *supra*, at 106.

148. *See* Drucker, *supra* note 147, at 106 (stating that institutional investors control as much as 40% of common stock in large and mid-size businesses); Siconolfi, *supra* note 18, at C1 (reporting that holdings by individual shareholders fell to 49.7% in second quarter of 1992). The concentration of institutional holdings in large companies was convincingly detailed in an SEC report on institutional investors. *See* 3 SEC INSTITUTIONAL INVESTOR STUDY REPORT, H.R. DOC. NO. 64, 92d Cong., 1st Sess. 1307 (1971). This SEC report concluded that "[i]nstitutions systematically hold a greater proportion of stocks with large market value than do individuals .... Institutions held extremely large percentages of the 27 largest stocks." *Id.* at 1317. These conclusions are also supported by the data from the Columbia Institutional Investor Project. C. BRANCATO, THE PIVOTAL ROLE OF INSTITUTIONAL INVESTORS IN CAPITAL MARKETS: A SUMMARY OF ECONOMIC RESEARCH AT THE COLUMBIA INSTITUTIONAL INVESTOR PROJECT tbls. 1, 2, 8, at 22-23 (June 14, 1990).

149. *See* Drucker, *supra* note 147, at 106 (noting that 20 largest pension funds now own nearly 10% of equity in America's publicly held corporations).

150. *See* LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 66-68 (1988). Lowenstein provides the following table, which clearly demonstrates the increasing rate of stock turnover:

ANNUAL TRADING—NEW YORK STOCK EXCHANGE		
Year	*Shares Traded (millions)*	*Annual Turnover Rate*
1960	767	12%
1965	1556	16%
1970	2937	19%
1975	4693	21%
1980	11,532	36%
1986	35,680	64%

Id. at 67, tbl. 3-2.

These figures are even more dramatic on closer examination because they do not include additional trading of NYSE-listed stocks in the over-the-counter markets, on regional exchanges, or in foreign markets. Once these trades are figured in, the actual "turnover in Exchange-listed stocks for 1986 was about 87 percent, not 64 percent." *Id.* at 67.

151. *See supra* note 142 (comparing results of two different studies on turnover rates).

share of stock in 1960, approximately 860 of those investors would retain ownership of their shares one year later. In contrast, if 1000 investors each purchased one share of stock today, chances are that 900 or more of those shareholders would *sell* their shares within a year.[152] In large part, institutional investors are responsible for this increased volatility; they account for nearly eighty percent of trading volume on the major American exchanges.[153]

These changes in patterns of stock ownership and retention lead to questions about the proper role of shareholders in corporate governance. Institutional shareholders with a significant investment in corporations have the practical ability to oversee management functions and operations at a meaningful level.[154] Because of their concentrated ownership, institutional investors have the economic incentive to assume responsibility for overseeing management.[155] Under the current proxy rules, which deprive shareholders of the opportunity to participate in corporate governance, shareholders have no option but to sell if they are dissatisfied with management.[156] This is likely to increase the turnover of corporate stock ownership, a phenomenon that is generally perceived as undesirable.[157]

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152. By 1986, the average trading volume had increased to 140 million shares per day, and one year later the average daily volume had increased to 188 million shares. Lowenstein & Millstein, *supra* note 142, at 743. If trades on markets other than the New York Stock Exchange are factored in, it is estimated that the actual turnover rate in 1987 approached 95%. *Id.*

153. A comprehensive study by the Securities Industry Association reported that 74% of the trading volume on the NYSE was attributable to trading by institutional investors. SIA RESEARCH DEP'T, TRENDS: AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY 4 (1989). The same study estimated that institutions were also responsible for 43% of all NASDAQ trading. *Id.*; *see also* Thomas C. Franco, *Institutional Ownership in the U.S.: An Overview*, *in* PLI, SHAREOWNER ACTIVISM: THE EMERGING ROLE OF INSTITUTIONAL INVESTORS 285, 288 (1987) (contending that increase in annual turnover rate on New York Stock Exchange from 13% in 1962 to over 50% in 1987 was due in large part to institutional dominance of equity markets).

154. *See* Louis Lowenstein, *Why Managements Should (and Should Not) Have Respect for Their Shareholders*, 17 J. CORP. L. 1, 3-6 (1991) (relating effectiveness of relationship between corporate management of General Motors and its large investor du Pont); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 453-59 (1991) (pointing out that any institutional investor with substantial holdings overcomes one obstacle facing scattered individual investors—collective action).

155. *See* Rock, *supra* note 154, at 460 (arguing that increased concentration of shareholding creates incentive to actively participate because better management will more directly benefit shareholder, result in less incentive to free ride, and undermine benefit of dumping shares because selling block all at once depresses price).

156. *See* Fischel, *supra* note 143, at 1277 (arguing that when shareholder is dissatisfied, logical course is to sell); *infra* text accompanying note 164 (describing policy of voting with one's feet, i.e. selling shares when unhappy with management).

157. *See* Lowenstein, *Stick & Carrot*, *supra* note 142, at 252 (noting that high turnover undermines operation of market and corporate governance, and focuses energies on short-term rather than long-term gains). The lack of investor loyalty and high turnover in stock portfolios make it virtually impossible for management to count on long-term shareholder support of proposals that require significant lead time. The high turnover also results in vastly increased transaction costs, which have been estimated to be as high as one-sixth of the underlying stream

Moreover, the existing management model has produced a number of highly questionable management decisions.[158]

The change in patterns of stock ownership in this country has been accompanied by a remarkable change in the ability of investors to exercise meaningful oversight of corporate management functions. When the average investor was an individual, rarely owning more than a tiny fraction of the total outstanding shares in a corporation, the business community reasonably assumed that investors generally lacked the resources, and probably the inclination, to supervise management decisions.[159] It was understandable and predictable that shareholders would leave corporate governance to management and allow management to control the selection of directors. In addition, management had a rational basis for its reluctance to approve greater shareholder participation in corporate governance. Allowing someone with inadequate resources to play a significant role in the management of a large enterprise would not merely have wasted time, it could also have damaged the corporation.

These concerns, however, do not accurately reflect the abilities of today's shareholders.[160] With the increasing prevalence of institutional investors in the marketplace, corporate governance regulations that leave no role for investor involvement in corporate decisionmaking are less tenable. Most institutional investors do have the resources and the financial incentives to undertake a more active role in corporate governance.[161] Indeed, they have shown an increased propensity to seek such involvement.[162] The question,

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of income. *Id.* Such transaction costs may benefit investment managers and stockbrokers, but they produce no real value for the traders or the companies whose stock is being traded and in fact decrease the amount of capital returned to investors and thus available for reinvestment.

158. *See infra* part II.A-B (discussing management decisions to richly compensate executives, initiate hostile takeovers, and reject tender offers).

159. *See supra* note 143 (acknowledging that individual investors lacked expertise and motivation to supervise management).

160. *See supra* note 145 (describing growth in institutional investors); *supra* note 154 (noting unique ability of institutional investor to oversee corporate functioning); *supra* note 155 (suggesting that institutional investors have special economic incentive to improve corporate operations).

161. *See* Lowenstein, *supra* note 154, at 4 (highlighting economic advantage du Pont had over individual investors when it came to buttressing GM when automobile manufacturer fell on hard times in 1920); Rock, *supra* note 154, at 460 (establishing that investor's motive is one of self-interest because it owns concentration of shares).

162. *See infra* part I.D (characterizing typical modern shareholder as institutional investor that puts more proposals forward and does not cede passively to management initiatives). While some institutional investors have adopted trading patterns with an exceedingly high turnover of stock ownership, others have sought an alternative to routine trading. This latter trend has been most recently referred to as "relationship investing." Judith H. Dobrzynski, *Relationship Investing*, BUS. WK., Mar. 15, 1993, at 68, 68. Relationship investing depends on the existence of an "established, committed relationship between a company and one or more shareholders." *Id.* Ideally, the result of this pattern is that management gets "patient capital and shareholders get

then, is whether we should retain corporate governance policies that prevent investors from assuming a meaningful role when the original justifications for those barriers no longer apply.

The answer to this question turns on two considerations. First, if corporations and their shareholders are unlikely to derive any practical benefit from permitting shareholder participation, it seems foolhardy to waste time and energy changing the existing rules. Second, if there are other reasons for precluding shareholder participation in management, it may not be desirable to change the rules simply because the original justification has ceased to exist.

Increased shareholder participation would likely produce the immediate practical benefit of providing a meaningful alternative to the Wall Street Rule,[163] which seems to be a driving force behind the high rate of turnover in stock ownership. The Wall Street Rule holds that shareholders who are dissatisfied with management decisions can "vote with their feet" by selling their shares and finding a different enterprise in which to invest.[164] As is becoming increasingly apparent, there are major problems with the Wall Street Rule. Clearly, it is an imperfect solution for dissatisfied shareholders: not only does it impose transaction costs, it also presumes the availability of acceptable substitute investments.[165] Large investors, however, often cannot locate suitable substitute investments.[166] Moreover, the

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management accountability and a better-run company." *Id.* at 69.

163. The Wall Street Rule tells investors to "vote with their feet"; that is, if they do not like management decisions, they should sell their stock rather than spend any time or effort trying to change management. Many supporters of the existing model of corporate governance, and its corollary, the Wall Street Rule, are highly critical of the short-term focus of modern investors. It is ironic that the very structure that they hope to protect actually encourages the short-termism that they criticize so intensely. *See infra* note 199 (describing short-termism as phenomenon of high turnover in ownership of companies).

164. *See* Lowenstein, *Stick & Carrot, supra* note 142, at 251 (referring to shareholders' ability to sell if they do not like management decisions).

165. *Cf.* Chris Welles, *The Future of Wall Street: Why Our Financial System Will Never Be the Same,* BUS. WK., Nov. 5, 1990, at 119, 120 (noting that transaction costs on New York Stock Exchange can be from two to eight percent per share).

166. *See* Lowenstein, *Stick & Carrot, supra* note 142, at 251-52 (suggesting that College Retirement Equities Fund (CREF) was involved in prominent proxy fight because it could not find appropriate substitute investments). CREF filed a shareholder proposal with International Paper Company asking that a proposed poison pill be submitted to the shareholders for their approval. A CREF spokesperson explained that the proposal was necessary because "so many other portfolio companies already have pills." *Id.*

In fact, there are numerous policies that are so prevalent that a dissatisfied shareholder would have a very hard time finding a substitute investment without similar drawbacks. An investor dissatisfied with the adoption of a shark repellent amendment would have to avoid 40% of the Fortune 500 companies. *See* John Pound, *The Effects of Antitakeover Amendments on Takeover Activity: Some Direct Evidence,* 30 J.L. & ECON. 353, 353 (1987) (citing INVESTOR RESPONSIBILITY RESEARCH CENTER, ANTITAKEOVER CHARTER AMENDMENTS: A DIRECTORY OF MAJOR AMERICAN CORPORATIONS (1985)). Similarly, if an investor wanted to find a company with confidential voting, as of 1989, only 20 publicly held American companies fit the bill. MCGURN, *supra* note

Wall Street Rule does not consider the growing possibility that an individual investor may own such a significant block of stock in a particular company that the very act of selling out would depress the market, resulting in a lower return on the investment than the market would normally provide.[167]

Finally, this "solution" ignores the fact that it leads to the high turnover of stock ownership that many authorities, especially those supportive of the current model of corporate governance, apparently believe to be inherently undesirable.[168] Legal and news commentators, financial analysts, and members of management are complaining that the high turnover of stock ownership in this country is producing a whole range of undesirable consequences.[169] First, it increases volatility in the capital markets.[170] Second, it forces management to make decisions that are profitable in the short term, even when other alternatives would produce superior long-term results.[171]

Increased shareholder participation in corporate governance could also produce a second potential benefit: better decisionmaking. Some directors have made some spectacularly poor decisions, at least from an economic perspective,[172] over objections by shareholders. The only remedy the current system provides is the Wall Street

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133, at 49. An investor objecting to a corporate policy permitting its CEO to earn more than $1,000,000 per year can eliminate the 173 companies that did pay their CEO in excess of $1,000,000 in 1991. Shawn Tully, *What CEO's Really Make*, FORTUNE, June 15, 1992, at 94, 98.

Investors seeking to avoid these objectionable policies must eliminate from the pool of possible investments most of the blue chip companies that institutional investors have traditionally preferred. When the investor has hundreds of millions of dollars to invest, eliminating the largest corporations from the pool of suitable investments often eliminates all viable substitutes.

167. *See* Howard D. Sherman, *Can Shareholders Call the Shots?* BUS. SOC. REV., Fall 1988, at 64 ("[T]oday's shareholders are simply too big to follow the Wall Street [R]ule. It's hard to sell out and find a new market when you *are* the market. . . . [T]he mere act of selling could depress share value . . . .").

168. *See supra* notes 152-53 and accompanying text (discussing increased stock turnover).

169. *See* Tamar Frankel, *What Can Be Done About Stock Market Volatility?*, 69 B.U. L. REV. 991, 991 (1989) (arguing that increased market volatility brought on by excessive trading creates "bubbles," rising market prices, which can produce inflation, or "runs," falling market prices, which can shrink consumption and production); Louis Lowenstein, *Stockholders, Humbug! Giving Them Top Dollar Could Cheat Us All*, WASH. POST, Jan. 14, 1990, at B1, B4 [hereinafter Lowenstein, *Stockholders, Humbug!*] (commenting that shareholders interested only in short-term profits, rather than seeing company through long-haul, often sacrifice company through schemes like leveraged buyouts of 1980s "which stripped the equity out of much of American industry").

170. *See supra* notes 151-53 and accompanying text (setting out turnover rates in stock ownership and attributing growth in rates to institutional investors).

171. *See* Lowenstein, *Stockholders, Humbug!*, *supra* note 169, at B4 (arguing that management must meet short-term goals of investors to keep them happy, which often undermines its ability to establish and achieve long-term goals).

172. *See infra* part II (pointing out areas of corporate decisionmaking that are especially contentious for shareholders).

Rule.[173] Allowing shareholders a meaningful opportunity to replace directors with their own nominees, however, would provide management with a meaningful incentive to improve decisionmaking.

Of course, benefits such as improved decisionmaking will be realized only if shareholders are both able and willing to assume an active role in corporate governance. Given that institutional investors have replaced individuals as the most common type of shareholder, it is now feasible for at least some shareholders to participate in corporate governance at a meaningful level if the barriers to such participation were removed. It is for this reason that the SEC should reexamine the rules and regulations limiting shareholder involvement in corporate governance.

D. *Attempts at Shareholder Activism*

As institutional investors have increased their ownership in American companies, they have also increased their interest in the management of these companies.[174] It is thus no longer accurate to depict the typical stockholder as a completely passive investor waiting for dividends to roll in. Shareholders are placing more initiatives on corporate ballots, and shareholder voting in recent years has shown increased opposition to certain management proposals.[175] Moreover, there is a marked divergence between the views of management and shareholder constituencies in the legal and business literature and in comments to suggested regulatory reforms.[176]

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173. *See supra* part I.B (discussing barriers to shareholder participation in corporate governance); *see also supra* notes 163-66 and accompanying text (discussing Wall Street Rule).

174. *See* Lowenstein & Millstein, *supra* note 142, at 743 ("Accompanying their increase in economic power has been a movement on the part of institutional investors to increase their participation in the corporate decision making process.").

175. *See* Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135, 1137 (1991) (maintaining that investors are issuing more proposals, banding together to oppose management proposals, and uniting to pressure management into reforms); Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 158-59 (1988) (discussing shareholder proposal campaign spearheaded by Teachers Insurance and Annuity Association and College Retirement Equities Fund (TIAA/CREF), one of oldest and most powerful pension funds, to require shareholder votes on management's adoption of poison pill amendment); Brett D. Fromson, *The Big Owners Roar*, FORTUNE, July 30, 1990, at 67, 67 (detailing growth of institutional investor activism since 1987, when institutional shareholders submitted total of 30 proposals and comparing this statistic with 98 resolutions submitted by July 1990); Dale M. Hanson, *Proxy Season: Victories Without Majorities*, PENSIONS & INVESTMENTS, July 23, 1990, at 16, 16 (commenting on increased shareholder activism and gains achieved by institutional investors even when their proposals did not win majority); Marcia Parker, *Funds Gird for Proxy Season*, PENSIONS & INVESTMENTS, Nov. 13, 1989, at 92, 92 (describing two shareholder proposals that called on corporations to submit plans to issue large blocks of stock or to amend bylaws for shareholder vote).

176. *See, e.g.*, Exchange Act Release No. 34-20,091, 48 Fed. Reg. 38,218, 38,218 (1983) (relaying debate about amendments to Rule 14a-8).

As shareholders have demonstrated an increased willingness to participate in corporate governance, there has been a corresponding increase in proposals designed to increase shareholder participation in corporate governance, and a growing shareholder hostility to certain resolutions promulgated by promanagement factions. Law review articles have urged various reforms designed to promote shareholder participation in corporate governance.[177] Similarly, the SEC adopted the most recent amendments to the federal proxy rules for the express purpose of fostering shareholder communication and the effective exercise of shareholder voting rights.[178] The ALI Corporate Governance Project also was designed to respond to the changing nature of American stockholders.[179]

Of course, any attempt to restructure corporate rules and regulations to permit shareholder participation in corporation governance would prove futile if shareholders showed absolutely no propensity to take advantage of such opportunities. In recent years, however, a growing body of evidence contradicts the notion that shareholders will always remain passive. Shareholder proposals, and shareholder votes cast in favor of such proposals, have become increasingly common.[180] Shareholder opposition to certain management proposals, particularly proposals to adopt takeover defenses, has also been on the rise.[181] Finally, shareholders are now more inclined to criticize

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177. *See, e.g.*, Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U. L. REV. 37 (1990) (advocating increased shareholder access to proxy process to improve shareholder role in selection of directors); Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 66-69 (1987) (calling for renewal of shareholder democracy by amending existing law to allow shareholders "free and equal access" to corporations' proxy machinery); Lowenstein, *Stick & Carrot*, *supra* note 142, at 256-57 (proposing that shareholders elect 20-25% of board separately from election of directors generally).

178. *See* Shareholder Communications, *supra* note 104, ¶ 85,051, at 83,355.

179. *See* ALI, CORPORATE GOVERNANCE, *supra* note 9, at 518-23 (recognizing that although shareholders must rely on management's professional expertise, they must have mechanisms to safeguard their interests).

180. *See* INVESTOR RESPONSIBILITY RESEARCH CTR., CORPORATE GOVERNANCE BULLETIN 115-23 (1990) [hereinafter IRRC CORPORATE GOVERNANCE BULLETIN] (presenting list of major shareholder proposals in 1990 and percentage of vote each received).

181. *See* JEFFREY W. BIERSHACH, CORPORATE GOVERNANCE SERVICE: VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES IN THE 1990 PROXY SEASON ii (1990) [hereinafter 1990 CORPORATE GOVERNANCE SURVEY] (presenting results of 1990 survey that show that institutional investors have continued trend, begun in late 1980s, of "fairly strong opposition to management anti-takeover provisions"). Opposition remained the same or increased on virtually every type of anti-takover device in 1989. *Id.* The Investor Responsibility Research Center (IRRC) is a non-profit research group that has conducted substantial research on institutional investor responses to anti-takeover devices such as unequal voting stock, limits on special shareholders' meetings, elimination of ability to act by written consents, adoption of a classified board, authorization of blank-check stock, and anti-greenmail provisions. *Id.*

management and promanagement regulatory schemes.[182] These facts point to the existence of increasingly aware and active shareholders.

Shareholders can formally express dissatisfaction with management policies by making their own proposals to other shareholders, and by staging or supporting proxy contests.[183] Of the two, the most common is the shareholder proposal; proxy contests are quite rare.[184] A review of shareholder proposals in recent years, however, reveals several important trends. First, shareholders are proposing more resolutions, especially resolutions relating to corporate governance.[185] Second, such proposals are receiving a greater share of the vote, even over management opposition.[186] Finally, recent proxy seasons clearly indicate a trend toward greater involvement by institutional investors.[187]

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182. *See* Robert D. Rosenbaum & Michael E. Korens, *Institutional Shareholder Activism and Related Proposals for Legislative and Regulatory Changes to Corporate Governance Rules*, *in* PLI PROXY CONTESTS, INSTITUTIONAL INVESTOR INITIATIVES, MANAGEMENT RESPONSES 621, 627-28 (1990) (discussing evolution of investors' attitudes from voting with management on all issues to actively opposing management proposals and putting forth own). Institutional investors are also organizing and lobbying the Securities and Exchange Commission for corporate governance reform. *Id.* at 632.

183. *See* Barnard, *supra* note 177, at 39 (explaining that shareholders may have their proposals circulated to other shareholders or may undertake independent proxy solicitation, which is very expensive).

184. Marilyn B. Cane, *The Revised SEC Shareholder Proxy Proposal System: Attitudes, Results and Perspectives*, 11 J. CORP. L. 57, 61 (1985) (contending that shareholder proposals are *only* formal means of determining management reaction to shareholder desires). An independent proxy solicitation most frequently occurs when a shareholder or outsider is seeking control of the corporation. Klaus Eppler & Edward W. Scheuermann, *Overview of the History and Current Uses of Proxy and Consent Solicitation Contests: Shareholder Challenges and Management Responses*, *in* PLI PROXY CONTESTS, INSTITUTIONAL INVESTOR INITIATIVES, MANAGEMENT RESPONSES 9, 16 (1990) (describing use of proxy to gain control when financing for tender offer is unavailable). Proxy fights are rare primarily because of the huge expenses involved. *See* Barnard, *supra* note 177, at 39. Once legal, printing and professional solicitation fees are added up, the total cost often runs into millions of dollars. *Id.*

185. *See supra* note 175; *see also* Cane, *supra* note 184, at 60 (describing proxy proposals covering issues from nomination of directors to prohibiting investments in South Africa); Rosenbaum & Korens, *supra* note 182, at 629 (stating that institutional-investor-sponsored proposals hit "all-time high" in 1989).

186. *See* WILLIAM F. SANDER, INVESTOR RESPONSIBILITY RESEARCH CTR., SHAREHOLDER VOTING ALMANAC 4-5 (1991) (noting that support for shareholder proposals has increased overall since 1986). In the area of shareholder proposals for confidential voting, there was an increase from an average of 9.5% of shares in support in 1987 to nearly 33.5% of shares in 1990. *Id.* at 5. Shareholder proposals to redeem or vote on poison pills, reduce supermajority vote requirements, opt out of state takeover laws, and repeal classified boards also received a high level of support in 1990. *Id.*

The increase in shareholder activism is even more evident when one notes that the only shareholder proposal to pass in 1986 had management support, while management did not support any of the 16 shareholder proposals that passed in 1990. *Id.* at 85.

187. *See* 1990 CORPORATE GOVERNANCE SURVEY, *supra* note 181, at 5 ("The results of the 1990 IRRC voting survey confirm the trend toward increasing institutional activism in the proxy voting process."). Institutions have continued their relatively high level of opposition to management

The Investor Responsibility Research Center (IRRC), a not-for-profit corporation formed in 1972 to compile and analyze information relating to institutional investors, conducts an annual survey on the response of institutional investors to corporate governance issues.[188] The responses of institutional investors over the past few years reveal that management can no longer depend on the support of institutional investors, particularly in the area of corporate governance.[189]

The IRRC reviews and tabulates data on shareholder proposals at approximately 1500 public companies.[190] This data indicates that in the 1987 proxy season, forty-six corporate governance resolutions, most of which related to takeover defenses, received more than twenty percent of the shareholder vote.[191] In 1988, fifty-eight shareholder resolutions received more than twenty percent of the vote.[192] Most of these proposals also related to takeover defenses, but other issues included cumulative voting, confidential voting, and access to the corporate proxy machinery.[193] In 1989, there were ninety-five such corporate governance proposals.[194] While more than half related to takeover defenses, nearly one-third supported confidential voting.[195] In 1990, 170 corporate governance proposals received more than twenty percent of the vote.[196] In fact, fourteen of these proposals received more than half of the votes cast.[197] The trends are clear: shareholders are making more proposals, which are receiving support from greater numbers of shareholders.

These shareholder proposals, and the support they have received, are not the only evidence that shareholders are increasingly dissatis-

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anti-takeover proposals, *id.* at 13, while increasing their level of support for shareholder proposals on corporate governance issues. *Id.* at 41. Institutional investors have also supported social responsibility shareholder resolutions. Pension funds, church groups, and educational institutions in particular showed a willingness to oppose management's viewpoint on social responsibility issues. INVESTOR RESPONSIBILITY RESEARCH CTR., HOW INSTITUTIONS VOTED ON SOCIAL POLICY SHAREHOLDER RESOLUTIONS IN THE 1990 PROXY SEASON 7 (Sept. 1990).

188. 1990 CORPORATE GOVERNANCE SURVEY, *supra* note 181, at ii.

189. *See* SANDER, *supra* note 186, at 10. While more shareholder proposals are passing, 16 in 1990, as opposed to one in 1986, *id.* at 85, more management proposals are failing, 22 in 1990, as opposed to four in 1988 and 14 in 1986. *Id.* at 10. Failed proposals have increased while the number of management proposals has decreased overall. *Id.*

190. *See* SANDER, *supra* note 186, at 1.

191. S. MARCIL & P. O'HARA, VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES IN THE 1987 PROXY SEASON 55-58 (1987).

192. P. BERGEN, VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES IN THE 1988 PROXY SEASON app. at 67-73 (1988).

193. *Id.*

194. L. KRASNOW, VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES IN THE 1989 PROXY SEASON 111-16 (1989).

195. *Id.*

196. IRRC CORPORATE GOVERNANCE BULLETIN, *supra* note 180, at 115-23.

197. IRRC CORPORATE GOVERNANCE BULLETIN, *supra* note 180, at 115-23.

fied with their minimal role in the current system of corporate governance. Public commentary provides evidence of increasing tensions between corporate management and institutional investors.[198] Charges of bias and shortsightedness, or short-termism,[199] are made on both sides, although such accusations have been accompanied by surprisingly little meaningful dialogue.[200] Management generally resists the mechanisms that institutional investors support, frequently on grounds of economic cost and inefficiency.[201] Investors, and commentators arguing on their behalf, respond with

198. On August 16, 1983, the SEC adopted amendments to Rule 14a-8, which governs shareholder proposals. SEC Exchange Act Release No. 34-20,091, 48 Fed. Reg. 38,218 (Aug. 16, 1983) (codified at 17 C.F.R. § 240.14a-8 (1990)). One clear example of the hostility toward management by pro-investor commentators is found in the literature debating these amendments.

Originally, the SEC submitted three proposed amendments to the public for review and comments. Exchange Act Release No. 34-19,135, 47 Fed. Reg. 47,420 (Oct. 26, 1982). The first proposal made only operational changes to the existing rule: it increased the stock ownership requirements, imposed a minimum holding period, limited the number of proposals, and changed the deadline for submission of proposals. *Id.* at 47,421. The second proposal allowed issuers to establish alternate procedures to govern shareholder proposals, and gave the corporation the authority to decide disputes concerning the interpretation of corporate rules. *Id.* at 47,422. The third proposal allowed all shareholder proposals permissible under state law, excluding matters relating to the election of directors, subject to a numerical maximum. *Id.*

Shareholder activist Lewis Gilbert called the first two proposals "perfectly outrageous." John Perham, *Uproar Over the Annual Meeting*, DUN'S BUS. MONTH, Apr. 1983, at 64, 68. Wilma Soss, president of the Federation of Women Shareholders, said that the second proposal would be "like putting Dracula in charge of the blood bank." *Id.* at 65. The second proposal was characterized as "a return to the law of the jungle." *Id.*

Management, on the other hand, criticized shareholder proposals as a waste of time and money. *See* Cane, *supra* note 184, at 70 (reporting that survey mailed to 448 Fortune 500 companies revealed that 72.9% of managers viewed shareholder proposals as "a waste of management's time and the corporation's money").

199. "Short-termism" is a term used to describe the phenomenon of high turnover in ownership of companies. *See* Barnard, *supra* note 177, at 41. An investor who buys stock and, within a short period of time, sells it and reinvests in another company is a short-term owner. The familiar Wall Street Rule, *see supra* notes 163-66 and accompanying text, helps to explain the prevalence of short-term investment strategies.

200. *See* A.A. Sommer, Jr., *Corporate Governance in the Nineties: Managers v. Institutions*, 59 U. CIN. L. REV. 357, 360 (1990) (remarking on tense relationship between management and institutional investors and observing that "[e]ach regards the other warily, suspiciously, apprehensively, and sometimes, with downright hostility"). The conflict between management and institutional investors was intensified with the takeover battles of the 1980s. Management viewed hostile tender offers as a threat to long-term plans, while institutional investors were often glad to accept the takeover premiums. Both sides have criticized the other for being unfairly biased in these takeover battles, and the hostility engendered by these disputes has not dissipated. *Id.*

201. *See* Shareholder Communications, *supra* note 104, at 83,357 (noting, for example, that when SEC solicited public comment on latest proposed amendments to proxy rules, proposals "elicited widespread approval" and further suggestions for reform from shareholders while "[t]he corporate community raised numerous objections to the proposals"). Many corporate commentators argued that "absent a filing obligation in connection with all communications among shareholders, the reforms would 'further the disturbing trend toward the determination of the outcome of shareholder voting by secret back-room lobbying of and negotiations with institutional investors.'" *Id.* (citing comment letter submitted by The Business Roundtable 2 (Sept. 18, 1991)).

policy arguments based on notions of democracy, typically ignoring management's claims of wasted resources, or employing different standards to evaluate efficiency of the shareholder proposal process.[202] Thus, the data suggests that institutional investors are increasingly willing to assume an active role in corporate governance issues. The question becomes whether it is desirable to offer institutional investors a greater role in corporate decisionmaking.

II. CURRENT PROBLEMS ATTRIBUTABLE TO MANAGEMENT DOMINATION OF CORPORATE GOVERNANCE

The only practical reason for abandoning the current model of corporate governance is if it is causing or contributing to poor decisionmaking. It would be far simpler if we could justify retaining our existing laws and regulations by concluding that our current system is functional, efficient, and not subject to substantial abuse. This approach is exemplified by the position of the Business Roundtable that "if it ain't broke, don't fix it."[203]

This position, taken by some business executives, corporate lawyers, and a few promanagement academicians, may appear to have some validity. A review of the voluminous commentary surrounding the state of corporate governance reveals that the bulk of the articles suggesting that it is time to modify the American model of corporate governance *assume* that the separation of ownership and control noted by Berle and Means creates problems.[204] Those commentators who do take the time to discuss specific problems tend to focus on the development of rules that insulate directors from accountability to the

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202. For example, some pro-shareholder commentators have suggested that it does not matter whether shareholder proposals are successful. *See, e.g.*, LOSS, *supra* note 121, at 477 ("It is not too important that these proposals are not carried . . . . The very opportunity to submit proposals, even of an advisory nature, affords a safety valve . . . .").

203. *See* Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163, 163-83 (1991) (explaining that as partner in Washington, D.C., firm of Arnold & Porter, author served as counsel to Business Roundtable and is familiar with Roundtable's position on corporate governance and its SEC submissions); *see also* Larry E. Ribstein, ed., *Edited Transcript of the Proceeding of the Business Roundtable/Emory University Law and Economics Center Conference on Remedies Under the ALI Proposals: Law and Economics*, 71 CORNELL L. REV. 357, 361 (1986) (remarks of Prof. Michael Bradley, University of Michigan Graduate School of Business) ("There is an issue of what is broken that needs to be fixed. Comments were made about the ravages in the market for corporate control and all of the abuses, but there has been no articulation of the problems at hand.").

204. *See, e.g.*, Cane, *supra* note 184, at 58-62 (discussing exclusion of shareholders and impact on corporate democracy, but not effect on corporate decisions); Sommer, *supra* note 200, at 357 (suggesting need for more independent and effective boards, but not discussing any problems arising from separation of ownership and control).

shareholders.[205] The assumptions made by these commentators critical of existing corporate governance models may be justified, but certainly a more detailed and direct examination of the extent to which management abuses occur is necessary in order to justify any significant reordering of power between shareholders and directors.[206]

In fact, there is evidence that the American model of corporate governance does not work as well as it should.[207] Certain patterns of abuse become clear upon examination of corporate decisionmaking in America.[208] Many decisions appear to be motivated more by self-interest than by concern for shareholders or even other constituencies.[209] Other decisions appear to be the result of sheer incompetence or inefficiency.[210] A system of corporate governance that provides some check against such abuses would seem preferable to one that allows them to occur unchecked. The accuracy of this conclusion, of course, turns on the accuracy of the observation that corporate decisionmaking in this country is flawed.

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205. *See, e.g.*, Barnard, *supra* note 177, at 37 (discussing failure of present system to provide shareholders with meaningful role, but not demonstrating that failure produces poor decisions); Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CAL. L. REV. 1671, 1678-1713 (1985) (detailing numerous obstacles to shareholder participation in corporate governance); Roberta S. Karmel, *Is It Time for a Federal Corporation Law?*, 57 BROOK. L. REV. 55, 57-70 (1991) (discussing barriers to shareholder participation in corporate governance as problem to be resolved); Bevis Longstreth, *Reflections on the State of Corporate Governance*, 57 BROOK. L. REV. 113, 114-20 (1991) (criticizing corporate developments that limit shareholder participation); John Matheson & Brent Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1315, 1323-51 (1992) (discussing in detail numerous barriers to shareholder participation in corporate governance and concluding that such barriers justify modification of existing rules).

206. Certainly a few authors have made an attempt to identify some of the problems occasioned by the imbalance of power between management and shareholders. *See, e.g.*, Bernard Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 898-913 (1992) (discussing bad takeovers, corporate cash retention policies, and management compensation as examples of shortfalls in corporate performance under current system); George W. Dent, *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 886-92 (suggesting that lack of shareholder involvement makes for decisions in certain areas that ignore shareholder interests); Lipton, *supra* note 177, at 1 (identifying abusive takeover tactics as existing problem).

207. *See* Nell Minow, *Proxy Reform: The Case for Increased Shareholder Communication*, 17 J. CORP. L. 149, 149-62 (1991) (responding to Business Roundtable's position that proxy reform is unnecessary). The author notes that "it is not surprising that the members of the Business Roundtable (and other representatives of management) argue that the current proxy rules work well. They are the primary beneficiaries of the current impediments to shareholder oversight." *Id.* at 156.

208. *See infra* part II (assessing abusive decisionmaking by directors and its impact on shareholders).

209. *See supra* part I.A (considering corporate decisions motivated by director self-interest).

210. *See infra* part II.B (reviewing cases involving poor corporate decisionmaking).

A. *Self-Interested Transactions*

At least in theory, state statutes place strict limitations on actions by directors who are personally interested in the subject matter of a particular transaction.[211] These limitations are subject to judicial enforcement.[212] It is often difficult, however, to convince the court that a particular action is self-interested.[213] One might assume, for example, that decisions regarding one's own salary would automatically qualify as self-interested. In fact, the same state statutes that purport to prohibit self-interested transactions typically grant directors authority to manage all business affairs, including compensation levels for themselves and for management.[214]

Similarly, one might assume that a decision about whether or not to sell control of the corporation,[215] which will inevitably affect the status of management, would be deemed self-interested. Certainly, one can see the possibility of a conflict of interest in asking a director to evaluate whether to sell a corporation, which might result in a profit to shareholders but a loss of the director's position with the

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211. *See, e.g.*, CAL. CORP. CODE § 310 (West 1990) (calling for full disclosure of material facts surrounding corporate transactions in which director has "material financial interest"); DEL. CODE ANN. tit. 8, § 144 (1991) (requiring directors make full disclosure as to their "interest and relationship with the transaction"); N.Y. BUS. CORP. LAW § 713 (McKinney 1986) (requiring disclosure of material facts surrounding transactions in which director has "substantial financial interest"); TEX. BUS. CORP. ACT ANN. art. 2.35-1 (West Supp. 1993) (demanding disclosure of material facts pertaining to director's relationship to and interests in transaction in which director has financial interest).

212. *See, e.g.*, Tevis v. Beigel, 344 P.2d 360, 362-66 (Cal. Ct. App. 1959) (discussing policies underlying California statute regarding transactions between corporation and director and applying statute to contract between corporation and interested director); Freedman v. Restaurant Assoc. Indus., Inc., Civ. Act. No. 9212, 1990 Del. Cas. LEXIS 142, at *19-23 (Del. Ch. Sept. 19, 1990) (interpreting and applying Delaware statute restricting directors' ability to engage in self-interested transactions).

213. *See, e.g.*, Alpert v. 28 Williams St. Corp., 473 N.E.2d 19, 24-28 (N.Y. 1984) (highlighting proof problems relating to valuation of assets, fair dealing, and full disclosure that plaintiff shareholders faced in suit alleging self-dealing by directors).

214. *See, e.g.*, CAL. CORP. CODE § 300(a) (West 1990) ("[T]he business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board."); DEL. CODE ANN. tit. 8, § 141 (1991) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ."); N.Y. BUS. CORP. LAW § 701 (McKinney 1986) ("[T]he business of a corporation shall be managed under the direction of its board of directors . . . ."); TEX. BUS. CORP. ACT ANN. art. 2.31 (West Supp. 1993) ("The powers of a corporation shall be exercised by or under the authority of, and the business and affairs of a corporation shall be managed under the direction of, the board of directors . . . .").

215. It is somewhat misleading to speak in terms of selling control. In actuality, a sale of control can be accomplished through a tender offer for outstanding shares, a sale of all or substantially all of the corporation's assets, or a merger, combination, or even a mandatory share exchange. All of these types of transactions can amount to an effective sale of control. *See* Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, *in* KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 314-22 (John Coffee et al. eds., 1988) (reviewing methods of corporate takeovers in terms of purchase and sale of corporate control).

company, or to fight the sale, which would allow the director to keep her position. Yet courts have allowed directors tremendous discretion in opposing takeovers.[216]

In fact, there are several types of decisions that have withstood judicial scrutiny, but seem suspect when viewed objectively.[217] Decisions regarding executive compensation and takeovers fall within this group. Unfortunately, as demonstrated by the following discussion, there are clear patterns of abuse in each of these areas.

1. *Executive compensation*

One issue that has garnered significant attention recently, especially in the popular press, is executive compensation.[218] The fascination with executive compensation stems in part from the huge numbers involved. In one survey, the median annual compensation package for CEOs of 200 of the largest American companies during 1991 was $2.4 million.[219] The highest paid executive in corporate America in 1991 earned at least $58.9 million.[220] In 1991, when a sizable

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216. *See infra* notes 283-95 and accompanying text (discussing judicial acquiescence to anti-takeover tactics and statutes).

217. For example, Professors Easterbrook and Fischel have complained that courts are too deferential to management in evaluating decisions relating to hostile tender offers. *See* Frank Easterbrook & Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1198-99 (1981) (arguing that business judgment rule should not be available to directors in hostile takeover context).

218. *See* Shawn Tully, *What CEOs Really Make*, FORTUNE, June 15, 1992, at 94, 94 (stating that increase in executive compensation packages in face of declining profits has led shareholders to call for reform). Executive compensation can take many forms. A corporate executive's total compensation is almost certain to consist of far more than basic salary. *See id.* (stating that in 1991, 19 top-paid CEOs received 86% of median total compensation in form of stock grants). Not only do most corporations offer substantial deferred compensation and pension plan payments, but in order to maximize income while minimizing taxability, corporations have also offered their executives rewards in the form of profit-sharing and stock bonus plans, non-qualified stock options, performance stock, and phantom stock. *See* George H. Foote, *Performance Shares Revitalize Executive Stock Plans*, HARV. BUS. REV., Nov.-Dec. 1973, at 121, 121-25 (documenting history, advantages, and disadvantages of performing shares as means of long-term executive compensation); Leo Herzl & Kenneth Perlman, *Stock Appreciation Rights*, 33 BUS. LAW. 749, 749-58 (1978) (reviewing use of stock appreciation rights as means of incentive compensation plans for officers and employees); Gerald Sherman, *Deferred Compensation—Qualified and Nonqualified: A Legislative Perspective Through the Tax Reform Act of 1969*, 11 WM. & MARY L. REV. 870, 872-94 (1970) (analyzing various types of deferred compensation arrangements and policy reasons behind them); Note, *Phantom Stock Plans*, 76 HARV. L. REV. 619, 619-22 (1963) (discussing use of deferred compensation plans as way to increase executive remuneration).

219. Tully, *supra* note 218, at 94-99 (reporting that median salary, including bonuses, was $1.2 million with average stock options and grants of restricted stock, doubling total value of compensation package).

220. Tully, *supra* note 218, at 94. Roberto C. Goizueta of Coca-Cola received this package, and $56 million of it was attributable to a million-share restricted stock grant. *Id.* Other sources reported that Anthony O'Reilly, CEO of H.J. Heinz, may have earned as much as $75 million during 1991. Steve Kichen & Eric Hardy, *Putting It in Perspective*, FORBES, May 25, 1992, at 174, 174; Maria Mallory, *Turning Ketchup into Big Dough*, BUS. WK., Mar. 30, 1992, at 58, 58.

number of American workers were unable to find any work at all,[221] an even dozen CEOs brought home more than $10 million in annual compensation.[222] Compensation for the top executives in American companies, on average, is about 160 times greater than an average employee's salary, and several times more than that earned by comparable executives in European and Japanese companies.[223]

Of course, the problem is not just the size of these numbers. If high executive compensation meant huge returns to shareholders, many shareholders would be willing to see CEOs take home huge bonuses, stock incentives, and salaries.[224] The evidence, however, suggests that the connection between CEO compensation and corporate performance is not particularly strong.[225] Executive compensation continues to rise at unprecedented rates despite economic problems for the rest of the country.[226]

Other top executives in American companies also fare quite well. The average chief financial officer earned in excess of $200,000 in base salary during 1991;[227] top marketing and sales executives

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221. *See* Adam Clymer, *House Approves Extended Benefits for Those Out of Work Six Months*, N.Y. TIMES, Nov. 15, 1991, at A16 (stating that over 300,000 workers in 34 states had been out of work for over 26 weeks); Marvin Newman, *November Jobless Rate in New York City Jumps to 10.2%*, N.Y. TIMES, Dec. 7, 1991, at A25.

222. Tully, *supra* note 218, at 95. The dozen were Roberto C. Goizueta (Coca-Cola: $58.9 million); Hamish Maxwell (Philip Morris: $29.9 million); Stanley C. Gault (Goodyear Tire & Rubber: $22.5 million); Lawrence A. Bossidy (Allied-Signal: $22.2 million); William A. Schreyer (Merrill Lynch: $15.75 million); Stephan M. Wolf (UAL: $14.2 million); Noland D. Archibald (Black & Decker: $13.5 million); Richard J. Mahoney (Monsanto: $10.6 million); John F. Welch, Jr. (General Electric: $10.25 million); William D. Smithburg (Quaker Oats: $10.2 million); and Richard D. Wood (Eli Lilly: $10.1 million). *Id.*

223. Judith Dobrzynski, *CEO Pay: Something Should Be Done—But Not by Congress*, BUS. WK., Feb. 3, 1992, at 29, 29 (arguing for implementation of new accounting rules and increased shareholder participation in order to curb abuses in executive compensation).

224. *See* Mallory, *supra* note 220, at 58 (observing that most shareholders would not object to large executive compensation packages provided that shareholders were receiving good return on their shares).

225. *See* Graef S. Crystal, *The Great CEO Pay Sweepstakes*, FORTUNE, June 18, 1990, at 94, 94-95 (stating that factors such as company size, performance, and business risk account for only 45% of variation in CEO compensation and concluding that market for CEO services is chaotic with respect to compensation).

226. Geoffrey Colvin, *How To Pay the CEO Right*, FORTUNE, Apr. 6, 1992, at 60, 61. Colvin describes trends in CEO compensation as follows:

> Largely unharnessed from corporate performance, the pay of America's CEOs has been galloping forward faster than the average production worker's pay, faster than corporate profits, industrial production, the national debt, the population of India, channels on cable TV, or just about anything else on earth but the number of newly independent republics.

Id.

227. Kenneth Labich, *The New Pay Game . . . And How You Measure Up*, FORTUNE, Oct. 19, 1992, at 116, 117. For companies in the manufacturing industry, the chief financial officers earned an average of $224,000, and for similar officials in wholesale/retail, the average income was $205,200. *Id.* at 116. These sums exclude bonuses, stock options, and stock grants. Only base salary is included in these figures.

earned an average of $135,000;[228] and the chief corporate information officer earned an average of approximately $130,000.[229] While generous, these salaries are not nearly as excessive as the compensation paid to CEOs in the same companies. Because the CEO is the single individual most likely to exert a significant influence on directoral decisionmaking,[230] this discrepancy in salary makes CEO compensation one area in which self-interest appears to play a major role.

In addition to comment in the popular press, the SEC has recognized that executive compensation is a serious issue for stockholders.[231] In light of the changing economic climate, the SEC revised its longstanding policy that prevented shareholders from including nonbinding resolutions on corporate pay policies in shareholder proposals; as currently interpreted, the proxy rules require management to include such proposals.[232] Even more recently, in the last round of amendments to the federal proxy rules, the SEC entirely revised the executive compensation disclosure requirements in an effort to make the disclosures more comprehensible.[233] None of these changes, however, go to the heart of the problem.

Shareholders are still not allowed a meaningful say in setting executive compensation. They can pass nonbinding resolutions, but they do not have even the ability to replace members of management who allow self-interest to cloud their decisionmaking on such issues as executive compensation.[234] Nor is it generally possible for them

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228. *Id.* at 117.

229. *Id.*

230. *See* Black, *supra* note 206, at 899-902 (contending that CEO often dominates board of directors). Frequently, this authority derives from the CEOs position as chairman of the board of directors. In this capacity, the CEO can set agendas, appoint committees, and exert tremendous influence over other board members. *Id.*

231. *See* Tully, *supra* note 218, at 94.

232. 17 C.F.R. § 240.14a-8 (1993). Of course, the shareholder resolutions are still nonbinding. *See* Jeffrey N. Gordon, *Corporate Law and Practice: Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 348 (1991) (discussing ineffectiveness of shareholder resolutions).

233. *See* Shareholder Communications, *supra* note 104, at 108-239 (citing need for more comprehensible executive compensation statements).

234. Frequently, state statutes or, more commonly, corporate bylaws grant the power to remove and replace directors to other directors, not to shareholders. *Compare* OHIO REV. CODE ANN. § 1701.58 (Page 1992) (granting power to remove director to directors) *with* DEL. CODE ANN. tit. 8, § 141(k) (1991) (granting shareholders power to remove unless provided otherwise in bylaws). Even where shareholders hold the technical power to remove and replace directors, the removal process would require a shareholder meeting and vote. *Id.* (requiring holders of majority of shares to vote for removal). Shareholders opposed to particular directors would thus be faced with all of the expenses and difficulties of waging a proxy fight, likely against management opposition. Moreover, because the business judgment rule is likely to protect most decisions involving compensation issues, shareholders would not even be able to remove

to rely on the Wall Street solution by finding a different company in which to invest because the problem of excessive executive compensation seems endemic to American corporations.

2. *Takeovers—the decision to acquire another corporation*

Yet another category of decisions that ought to be suspect, but is instead accorded essentially the full protection of the business judgment rule, involves the initiation of hostile tender offers. While it is true that commentators offered a large number of theories[235] attempting to explain the takeover frenzy[236] of the 1980s, one of the most intriguing hypotheses was that directors liked to acquire other corporations because such acquisitions provided top management with benefits such as increased compensation, prestige, power, and job security.[237] Some commentators have described this theory as the empire-building hypothesis or the firm-expansion theory.[238] This theory suggests that the traditional explanations offered in support of the wave of takeovers during the 1980s were inaccurate or, at best, incomplete.

For example, one of the principal justifications offered in support of hostile tender offers was the notion that takeovers increased efficiency by replacing inefficient management with better managers.[239] This hypothesis suggests that hostile takeovers are economically desirable because the bidding company's management would operate more efficiently than would existing management, and the expected increase in efficiency would raise the value of the target after acquisition.[240] Evidence, however, does not support this

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directors by bringing a direct or derivative action. *See supra* notes 56-63 and accompanying text (discussing removal of directors for cause).

235. *See* Richard Roll, *Empirical Evidence on Takeover Activity and Shareholder Wealth*, *in* KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER, *supra* note 215, at 243-50 (listing seven possible explanations for wave of mergers and acquisitions that characterized 1980s).

236. The staggering level of takeover activity during the 1980s was the subject of much comment. In 1986 alone, more than 4000 merger and acquisition transactions involving assets in excess of $190.5 billion were consummated. *See* Deborah De Mott, *Directors' Duties in Management Buyouts and Leveraged Recapitalizations*, 49 OHIO ST. L.J. 517, 517-20 (1988) (analyzing legal, economic, and social concerns surrounding management buyouts and leveraged recapitalization).

237. *See, e.g.*, Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1033 (1982) (suggesting that bidding management may initiate hostile tender offer out of interests such as desire for power and prestige).

238. *See, e.g.*, Gregory Andre, *Tender Offers for Corporate Control: A Critical Analysis and Proposals for Reform*, 12 DEL. J. CORP. L. 865, 874-75 (1987) (stating that management's preference for expansion probably is ancillary motive in takeover decision); Bebchuk, *supra* note 237, at 1030-33 (arguing that dominant motives for tender offers are creation of economies of scale in production, marketing, control, reduced cost of capital, and tax savings).

239. Andre, *supra* note 238, at 872-73.

240. Andre, *supra* note 238, at 872-73.

theory. Studies indicate that most bidders sought targets with excellent management,[241] and two-thirds of successful acquirors allowed the acquired firm to retain control over operating decisions.[242] In addition, the value of the acquired firm often did not increase after acquisition.[243]

Another justification offered in support of takeovers was the synergistic-gains theory.[244] This hypothesis suggests that bidders engage in hostile tender offers because the target has a unique value to the bidder, and because combining the firms will allow the realization of synergistic gains.[245] But like the efficiency theory, the evidence does not support the synergistic-gains theory. In fact, such gains rarely materialize.[246]

The empire-building hypothesis does not attribute noble or economically desirable motives to the management of bidding companies. It suggests that the motivation behind hostile takeovers is not to achieve higher rates of return to shareholders of the bidding corporation, but rather to accommodate the self-interest of the directors initiating the takeovers.[247] Simply put, there are a number of studies suggesting that there is a high correlation between firm size and executive compensation.[248] There are also a number of studies suggesting that the bidding corporation's shareholders derive no significant economic benefits from hostile takeover activity,[249] and

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241. *See* John Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1212 (1984) (citing 1981 study by Touche Ross & Co. that stated that 84% of bidding companies surveyed listed excellent management as major factor in selecting takeover target).

242. *Id.*

243. Black, *supra* note 206, at 906.

244. Coffee, *supra* note 241, at 1166.

245. Coffee, *supra* note 241, at 1166 (explaining that synergistic-gains theory justifies hostile takeovers by listing characteristics of target firm that would increase value to bidder to level above market prices).

246. Coffee, *supra* note 241, at 1224. In addition, the synergistic-gains theory fails to explain why target management opposes most of these transactions that, in theory at least, should produce increased wealth for both parties. *Id.* at 1167.

247. *See* Bebchuk, *supra* note 237, at 1033 (suggesting that some hostile offerors are motivated by self-interest).

248. CHARLES A. PECK, TOP EXECUTIVE COMPENSATION 2-7 (1987); *see also* Coffee, *supra* note 241, at 1167 n.50 (outlining studies that find strong connection between firm size and executive compensation). According to studies conducted by Charles Peck at the Conference Board, one-half of the variation in compensation in corporate CEOs is attributable to company size measured by gross sales rather than profits. PECK, *supra*, at 3-7.

249. *See* J. GRUNDFEST & B. BLACK, SEC. & EXCH. COMM'N, STOCK MARKET PROFITS FROM TAKEOVER ACTIVITY BETWEEN 1981 AND 1986 (1987) (reporting five year study by SEC that revealed that average above-market return to bidding firms was -0.04% for 30 day period beginning 10 days before takeover announcement to 20 days after); Murray Weidenbaum & Stephen Vogt, *Takeovers and Stockholders: Winners and Losers*, CAL. MGMT. REV., Summer 1987, at 157, 157-68 (concluding that shareholders of target corporation benefit while shareholders of bidding firm lose on their investment). *But see* Jensen, *supra* note 215, at 314-22 (citing

that in fact, such acquisitions may actually harm the bidding corporation.[250] Given this evidence, it is hard to avoid the conclusion that self-interest plays a role in the takeover markets.[251] In many cases, one can argue that there is only one plausible explanation[252] for the fact that directors of bidding companies are willing to expend millions of dollars to engage in a takeover battle when there is no evidence that their shareholders will realize any increased rates of return: directors are concerned with something other than the interests of their shareholders.[253]

In some ways, the problems with takeovers are a concern of the past. Many states amended their statutes to impose substantial barriers to hostile tender offers,[254] and most corporations have amended their corporate charters to incorporate an incredible array of defensive tactics designed to fend off hostile offers.[255] Moreover,

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returns to bidding firms as high as four percent). Other sources complain that the evidence is insufficient to determine if there are any returns. *See* Roll, *supra* note 235, at 244-50 (stating that there is not enough empirical evidence on takeover activity to support particular social policy). It is not just the short-term returns that appear doubtful. The overall impact of takeovers on bidders has also been questioned. At least one commentator has concluded that, "even in the 1980's, a period of relative prosperity, the bidders suffered an immediate and sharp decline in profitability." Edward S. Herman & Louis Lowenstein, *The Efficiency Effects of Hostile Takeovers, in* KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER, *supra* note 215, at 231.

250. *See* William Proxmire, *What's Right and Wrong About Hostile Takeovers*, 1988 WIS. L. REV. 353, 361 n.17 (noting that one study examined share prices for successful bidding corporations and found that, within three years of successful merger, price of shares in surviving firm actually declined significantly) (citing Magenheim & Dennis Mueller, On Measuring the Effect of Acquiring Firm Stockholders (paper prepared for Columbia Law School Conference on Takeovers and Contests for Corporate Control, Nov. 15, 1985)).

251. *See, e.g.*, Jensen, *supra* note 215, at 314-22 (arguing that market for corporate control is nothing more than arena in which managers compete for right to manage); Roll, *supra* note 235, at 250 (discussing management self-interest as one possible motive for takeover activity); Murray Weidenbaum, *Lessons of an Outside Director*, 70 WASH. U. L.Q. 563, 568 (1992) (concluding that self-interest dominates decisionmaking process of corporate directors with regard to initiating takeovers).

252. There are, of course, plenty of implausible explanations. For example, those closely involved in staging hostile takeover battles claim that they are more concerned about shareholders than the entrenched management. As another commentator has noted, "It strains credulity to believe that the managers of acquiring companies are so idealistic that they are willing to risk the assets of their own shareholders to liberate the downtrodden shareholders of the target firms. Some other explanation must be sought." Weidenbaum, *supra* note 251, at 568.

253. *See* Coffee, *supra* note 241, at 1168 ("[T]he most important conflict of interest in corporate control may be on the bidder's side of the transaction—between the interest of the bidder's management and those of its own shareholders.").

254. *See, e.g.*, DEL. CODE ANN. tit. 8, § 203 (1991) (limiting acquiror's ability to control acquired corporation by preventing acquiror from engaging in certain business relationships with acquired company for three years following acquisition); IND. CODE ANN. §§ 23-1 to 42-9 (Burns 1989) (placing restraints on acquiror's ability to exert its power once it has purchased certain percentage of target's shares).

255. *See* Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: Bridging the Unocal/Revlon Gap*, 35 ARIZ. L. REV. 989, 989-95 (1993) (indicating that many corporations have amended corporate charters to include wide variety of defenses to hostile tender offers); *infra* notes 267-75

the junk-bond market, which funded many of these acquisitions, collapsed amid scandal.[256] The wave of takeover activity appears to have subsided.

These changes have all occurred, however, without addressing the fundamental defect that allowed the problem to surface in the first instance. The "solutions" to the takeover frenzy work primarily by giving the target's management greater authority to withstand attempts by the bidding company's management to acquire the target. The new rules actually give management additional authority to act without considering shareholder interests.[257] It is ironic that legislators chose to address concerns regarding takeovers[258] not by confronting the cause of the problem,[259] but by creating another problem: the entrenchment of management permitted by the new anti-takeover legislation.[260]

3. *Takeovers—the decision to oppose a tender offer*

While evidence suggests that tender offers do not net a statistically significant rate of return for shareholders of bidding corporations,[261] shareholders of target corporations are in an entirely

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(explaining several types of takeover defenses that have been included in corporate charters).

256. *See Ex-Officers of Drexel Penalized*, N.Y. TIMES, May 21, 1993, at D1 (outlining various scandals that led to collapse of junk-bond market).

257. At first glance it might appear that this statement could not be true. How could giving management greater power be a solution to excessive power held by management? The answer lies in the fact that there are at least two corporations involved in any takeover—the bidder and the target. Abuses of power by the bidder's management, that is the decision to engage in a hostile takeover for personal gain, can be stopped by allowing management of the target greater authority. If the directors of bidding corporations were the only ones abusing or prone to abusing their authority, allowing target management greater flexibility and power in resisting a takeover would not have been a problem. In reality, abuses could and did exist on both sides of such transactions. Where target shareholders stood to realize economic gains from the takeovers, a management decision to oppose the takeover was also abusive, and the losers on both sides were the shareholder constituencies.

258. *See Takeover Inc.: The Auctioning for American Business Not a Bargain for All*, CHI. TRIB., Sept. 20, 1987, at C1 (noting that many 1980s takeovers not only did not produce anticipated economic gains, but in fact resulted in number of undesirable economic consequences). Businesses failed or were sold off piecemeal; jobs and production capacity were lost; the value of the surviving corporation, as measured by market price of stock, actually declined. *See* Richard A. Booth, *The Problem with Federal Tender Offer Law*, 77 CAL. L. REV. 707, 709-13 (1989) (addressing negative consequences of hostile takeovers).

259. According to the empire-building theory, the cause is directors acting out of self-interest. *See* Andre, *supra* note 238, at 875 (analyzing study showing high correlation between management compensation and company size but little correlation between compensation and return to shareholders, and suggesting that this data indicates that directors act out of self-interest).

260. *See infra* part II.A.3 (explaining how new anti-takeover statutes benefit management at expense of shareholders).

261. Weidenbaum & Vogt, *supra* note 249, at 157-68.

different position.[262] During the five-year period from 1981 to 1986, the gain to target-firm shareholders was approximately $123 billion.[263] This gain translates into a premium of between thirty and fifty percent for shareholders of target companies.[264]

One might expect that if directors of bidding corporations were willing to risk the assets of their shareholders for a marginal rate of return at most, then directors of targets would jump at the chance to realize a tremendous premium for their shareholders. The reality, of course, is to the contrary.[265] Over the objections of target shareholders, target management often works diligently to thwart takeover attempts.[266]

Corporate management has developed a bewildering array of defensive devices to fend off unwelcome tender offers. Recognized defensive tactics include shark-repellent amendments,[267] lock-up options with a white knight,[268] greenmail,[269] poison pills,[270] gold-

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262. *See* Weidenbaum & Vogt, *supra* note 249, at 157-68 (stating that shareholders of target firm can profit from takeover).

263. GRUNDFEST & BLACK, *supra* note 249.

264. *See* Jensen, *supra* note 215, at 314-22 (elaborating on financial gains available to shareholders of target corporation).

265. *See* Weidenbaum & Vogt, *supra* note 249, at 568 (maintaining that directors of target corporations often do not act in best interest of shareholders).

266. *See* Coffee, *supra* note 241, at 1160-65 (discussing conflicts that arise between directors and shareholders of target corporations).

267. *See* Ellen Friedenberg, *Jaws III: The Impropriety of Shark-Repellent Amendments as a Takeover Defense*, 7 DEL. J. CORP. L. 32, 34 (1982) (describing shark repellent as any provision in target company's articles of incorporation, such as staggered board provision, fair price amendments, or super-majority voting requirements, designed to deter hostile tender offers).

268. A "lock-up" is a contractual arrangement with a friendly suitor (the "white knight") that gives the latter an advantage in bidding for the target company. Stephen Fraden & Joseph Franco, *Lock-Up Arrangements*, 14 REV. SEC. REG. 821, 821 (1981). The white knight is given either an option to purchase assets of the target (an asset lock-up, where particularly valuable assets may be referred to as "crown jewels"), or target stock (a stock lock-up) in an attempt to deter a suitor from continuing with a hostile takeover. *Id.* at 823-24. For a discussion of lock-ups, see Arthur Fleischer, TENDER OFFERS: DEFENSES, RESPONSES AND PLANNING 326 (1983) (discussing use of lock-up arrangement as defensive measure designed to thwart hostile tender offer); Arthur Fleischer & Daniel Sternberg, *Corporate Acquisitions*, 12 REV. SEC. REG. 937, 937-41 (1979) (reviewing uses of lock-up agreements and delineating several variations on standard lock-up agreement); Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621 (1983) (analyzing use of lock-up amendments in context of business judgment rule).

269. *See* Note, *Greenmail: Targeted Stock Repurchases and the Management-Entrenchment Hypothesis*, 98 HARV. L. REV. 1045, 1045-46 (1985) (defining greenmail as defensive tactic whereby target corporation repurchases securities from potential hostile suitor at premium price).

270. Poison pills take the form of preferred stock that is authorized, but unissued, until a triggering event, such as a hostile tender offer, occurs. *See* Krishnan Chittur, *Wall Street's Teddy Bear: The Poison Pill as a Takeover Defense*, 11 J. CORP. L. 25, 26-40 (1985). When triggered, the poison pills are issued, and existing stockholders are given the right to acquire additional shares of the company's stock at below-market prices. In addition, the poison pill may include a flip-over provision, which allows shareholders to acquire shares of a successful bidding company at below-market prices.

en parachutes for management,[271] and, if all else fails, a management buyout.[272] The Pac-Man Defense, where the target turns around and makes a bid for the stock of the original bidder, was not uncommon.[273] The Nancy Reagan, or "Just say no," defense was also popular.[274] In extreme cases, some targets chose a scorched-earth defense[275] rather than permit another company to complete the acquisition. It is true, however, that a truly determined bidder could overcome most of these defenses.[276]

Promanagement factions, not content with anti-takeover defenses imposed only at the corporate level, lobbied extensively for the creation of anti-takeover legislation.[277] The first of such statutes generally sought to impose affirmative obligations and limitations on a tender offeror.[278] For example, the Illinois legislation imposed a 20-day precommencement period before a tender offeror could proceed with a tender offer.[279] In *Edgar v. MITE Corp.*,[280] however, the U.S. Supreme Court determined that the Williams Act preempted

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271. A golden parachute is a contractual arrangement between the target and one or more executive officers whereby the target promises to provide the executive with substantial benefits over and above those the executive would normally receive if the officer is terminated as a result of a change in corporate control. *See* Martin Riger, *On Golden Parachutes—Ripcords or Ripoffs? Some Comments on Special Termination Agreements*, 3 PACE L. REV. 15, 17-19 (1982) (analyzing validity and justifiability of golden parachutes). These agreements are also referred to as special termination agreements. *Id.* at 16.

272. For a discussion of management buyouts, see Scott V. Simpson, *The Emerging Role of the Special Committee—Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest*, 43 BUS. LAW. 665 (1988).

273. *See* Deborah DeMott, Comment, *Pac-Man Tender Offers*, 1983 DUKE L.J. 116, 119 (considering pac-man strategy as defense to potential takeover).

274. *See* Robert A. Prentile & John H. Langmore, *Hostile Tender Offers and The "Nancy Reagan Defense": May Target Boards "Just Say No"? Should They Be Allowed To?*, 15 DEL. J. CORP. L. 377, 412-60 (1990) (characterizing Nancy Reagan defense as refusal by target board to agree to takeover on any terms).

275. A target would employ a scorched-earth defense to make itself utterly unattractive to a bidding company. *See* Leonard I. Reiser, *Corporate Takeovers: A Glossary of Terms and Tactics*, CASE & COM., Nov.-Dec. 1984, at 35, 35. This defense may include any of a number of tactics: selling off the crown jewels, orchestrating a mass exodus of top management, bestowing a huge cash dividend to shareholders to empty the treasury, bloating the company with debt, or buying back large amounts of stock to reduce equity. *Id.* at 48-49 (describing numerous terms associated with corporate takeovers, including scorched-earth defense).

276. *See* Booth, *supra* note 258, at 708-10 (stating that unwelcome takeovers often succeed because bidder may possess secret information or more competent management, and large shareholders of target corporation may sell stock despite rejection of offer by target board).

277. *See Merger Mania: Don't Blame "Raiders" for Systemwide Abuses*, LEGAL TIMES, Apr. 4, 1988, at 16 [hereinafter *Merger Mania*] (finding that promanagement groups have succeeded in obtaining passage of numerous anti-takeover statutes).

278. *See* ILL. REV. STAT. ch. 121 1/2, paras. 137.51 to 137.55 (1979) (limiting tender offeror's ability to acquire target); *see also* 70 PA. CONS. STAT. ANN. §§ 72-75 (1993) (restricting ability of bidding corporation to make successful tender offer by restricting voting ability of acquiror as well as its ability to engage in business relationships with acquired company).

279. ILL. REV. STAT. ch. 121 1/2, paras. 137.51 to 137.55 (1979).

280. 457 U.S. 624 (1982).

the Illinois statute.[281] The plurality opinion reasoned that any state legislation that would upset the congressionally mandated balance between management and a tender offeror was impermissible.[282]

In response to this setback, proponents of anti-takeover legislation successfully lobbied for a new generation of anti-takeover statutes.[283] The Supreme Court has upheld these statutes[284] even though they can impose very formidable barriers to hostile acquisitions. For example, the Indiana statute, which was upheld in *CTS Corp. v. Dynamics Corp. of America*,[285] provides that a shareholder acquiring "control shares"[286] can vote those shares only after the approval of disinterested directors or disinterested shareholders.[287] Moreover, the corporation is given the option to redeem the shares if the disinterested shareholders do not restore voting rights.[288] This type of statute is known as a control share provision, and Indiana is not alone in enacting such legislation.[289]

Yet another type of state statute acts to prohibit a corporation from entering into a business combination with any shareholder owning more than a specified minimum number of shares without approval by disinterested directors or shareholders, or compliance with other requirements.[290] Such limitations on business combinations affect tender offers by making it impossible for acquirors to effect a squeeze-out merger or other reorganization that would be necessary for the acquiror to gain total control over the target.[291]

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281. Edgar v. MITE Corp., 457 U.S. 624, 636-38 (1982).

282. *Id.* at 632-34.

283. *See Merger Mania, supra* note 277, at 16 (highlighting role of promanagement groups in promoting takeover legislation).

284. CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 94 (1987) (upholding constitutionality of Indiana statute designed to protect shareholder of target corporation during tender offer).

285. 481 U.S. 69 (1987).

286. IND. CODE ANN. § 23-1-42-1 (Burns 1989) (defining "control shares" as shares that, but for operation of Act, would bring acquiror's voting control to or above any of three thresholds: 20%, 33 1/3%, or majority).

287. *Id.* § 23-1-42-9.

288. *Id.* § 23-1-42-10.

289. *See, e.g.*, 15 PA. CONS. STAT. §§ 2561-2568 (1993) (placing restrictions on control shares).

290. *See, e.g.*, DEL. CODE ANN. tit. 8, § 203 (1991) (prohibiting business combinations with any shareholder who owns 15% or more of outstanding shares, unless: board approves combination, shareholder acquires more than 85% of all outstanding shares, or two-thirds of disinterested shareholders approve combination); N.Y. BUS. CORP. LAW § 912 (McKinney 1986) (prohibiting business combinations with shareholders owning more than 20% of corporation's stock, absent approval by disinterested directors or disinterested shareholders, or minimum purchase price paid to all shareholders).

291. A squeeze-out merger is the second step in a two step process. *See* Thomas R. Wilcox, *Delaware's Attempt to Swallow a New Takeover Defense: The Poison Pill Preferred Stock*, 10 DEL. CORP. L. 569, 571 (1986) (describing squeeze-out merger). In the typical squeeze-out merger situation, the acquiror would obtain a majority share of the target's stock by paying a premium on that stock. *Id.* Then, once in control of the company, the acquiror would force the remaining

While takeover defenses and anti-takeover legislation are typically justified in terms of "protecting" shareholders from "unfair" or "inadequate" tender offers,[292] they often operate to prevent shareholders from receiving a substantial premium for their stock[293] and allow management to retain their positions.[294] From the viewpoint of the shareholders of potential target corporations, these devices and statutes are economically inefficient[295] because they benefit management at the expense of shareholder interests.

B. *Poor Decisionmaking*

Decisions regarding executive compensation, the initiation of tender offers, and the responses thereto offer some of the most prevalent examples of questionable decisionmaking in corporate America. They are by no means, however, the only types of decisions that are subject to attack by shareholders who have not been well served by their "fiduciaries" on the board of directors. Case law is replete with examples of decisions protecting directors from liability for negligent actions.[296]

One of the more infamous cases regarding directoral discretion is *Kamin v. American Express.*[297] *Kamin* involved a decision by the board of directors to elect an in-kind distribution of depreciated property in

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shareholders to turn over their shares for a lower price or less valuable consideration, thereby completing the merger. *Id.*

292. *See, e.g.*, Moran v. Household Int'l, 500 A.2d 1346, 1348 (Del. 1985) (allowing plan instituted by board of directors ostensibly designed to protect shareholders by warding off unfair tender offers).

293. *See* Coffee, *supra* note 241, at 1155-65 (asserting that target management should be accorded less discretion in responding to takeover bids because target shareholders are in position to profit from takeover).

294. *See* Coffee, *supra* note 241, at 1155-65 (suggesting that takeover defenses allow management to retain their positions at expense of shareholders).

295. "Inefficient" in this context refers only to the fact that by preventing successful tender offers, management prevents shareholders from realizing maximum immediate gain from their investment. This assumes, of course, that shareholders' only motive in investing is profit, an assumption that is consistent with economic theory.

296. *See, e.g.*, Levine v. Smith, 591 A.2d 194, 214 (Del. 1991) (declining to hold directors liable for authorizing repurchase of single large shareholder's stock); Shlensky v. Wrigley, 237 N.E.2d 776, 780-81 (Ill. 1968) (refusing to hold directors liable for alleged losses resulting from refusal to install lights in Wrigley Field); Kamin v. American Express, 383 N.Y.S.2d 807, 810-12 (Sup. Ct.) (holding that, absent fraud, oppression, arbitrary action, or breach of trust, plaintiff shareholders could not state cause of action against directors for negligent declaration of dividends), *aff'd*, 387 N.Y.S.2d 993 (App. Div. 1976). These decisions are consistent with the business judgment rule. *See* HENN & ALEXANDER, *supra* note 8, § 242 (stating that business judgment rule shields directors from liability if transaction was reasonable and within corporation's power and directors' authority); *supra* part I.A.1 (discussing application of business judgment rule).

297. 383 N.Y.S.2d 807 (Sup. Ct.), *aff'd*, 387 N.Y.S.2d 993 (App. Div. 1976).

order to avoid recognition of the loss at the corporate level.[298] This decision resulted in the corporation losing an $8 million tax savings.[299] The directors, apparently fully aware of the tax consequences of their decision, justified their actions by suggesting that a loss of $25 million would have a negative impact on the net income figures in the American Express financial statement.[300] Absent fraud, dishonesty, or nonfeasance, the court held that disgruntled shareholders had no recourse against the directors who had unanimously voted in favor of a decision that cost the company $8 million.[301] Economically, the decision was unjustifiable. Nonetheless, the court precluded dissatisfied shareholders from recovering against the directors who had made the decision.[302]

Equally disturbing from a purely economic perspective is *Shlensky v. Wrigley*.[303] In *Shlensky*, Phillip Wrigley, president of the corporation and owner of approximately eighty percent of the outstanding shares,[304] refused to install lights at Wrigley Field, home of the Chicago Cubs.[305] The complaint alleged that the decision not to install lights was made "regardless of financial benefits"[306] because baseball was meant to be a day game.[307] Wrigley Field was, at that time, the last major league stadium not equipped with lights for night games.[308] The court concluded that the case was not subject to judicial review absent allegations of "fraud, illegality or conflict of interest."[309] This case supports the conclusion that directors are not held accountable to public shareholders, even for decisions that ignore shareholders' financial interests.

Yet another example of corporate decisionmaking run amok is *Levine v. Smith*.[310] *Levine*, a consolidation of two derivative actions, addressed complaints regarding the decision of General Motors'

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298. 383 N.Y.S.2d at 809.
299. *Id.* at 810.
300. *Id.* at 811.
301. *Id.* at 812.
302. *Id.*
303. 237 N.E.2d 776 (Ill. 1968).
304. Shlensky v. Wrigley, 237 N.E.2d 776, 799 (Ill. 1968).
305. *Id.* at 777.
306. *Id.* at 778.
307. Arguably, this case is more supportable on policy grounds because a number of baseball fans maintain to this day that our national pastime ought to be played in the full light of day, not under artificial lights at night. *See* Ed Condrane, *Take Me Out to the Ball Parks*, TIMES-PICAYUNE, July 11, 1993, at E1 (reporting that many Cubs fans opposed installation of lights at Wrigley Field).
308. *Id.* (explaining why Cubs played all home games during day).
309. *Shlensky*, 237 N.E.2d at 780.
310. 591 A.2d 194 (Del. 1991).

board of directors to buy out Ross Perot and several of his associates.[311] Ross Perot had originally acquired his GM securities in connection with his 1984 sale of Electronic Data Systems Corporation (EDS) to GM.[312] Following the transfer, Perot continued to operate EDS as a GM subsidiary.[313] He had also become GM's single largest individual shareholder and a member of the GM board of directors.[314]

The GM board decided to buy back Perot's interest in GM after Perot publicly and continuously criticized GM management.[315] The GM board paid Perot and his associates approximately $742.8 million for his stock and notes.[316] One commentator characterized this payment as "no more than a bribe—a bribe paid to a favored insider, no less!"[317] Regardless, the court did not allow shareholders to prevent management from buying the "favored insider's" stock at prices that substantially exceeded market value and were not available to other shareholders.[318]

In all of the above cases, the courts precluded disgruntled shareholders from pursuing a judicial remedy against the directors. This failure would be less significant if the dissatisfied shareholders had the ability to replace directors guilty of such poor decisionmaking at their next annual meeting. In fact, it often appears that judges assume that dissatisfied shareholders will have the opportunity to vote out offending directors.[319] In reality, as indicated in other parts of this Article, shareholders seldom have any such option.[320]

In addition to these specific examples of decisions that appear economically irrational from the shareholders' perspective, there is growing evidence of general dissatisfaction with corporate decisionmaking.[321] One indication of the potential magnitude of the problem is the number of recent proposals for reform. Professor

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311. Levine v. Smith, 591 A.2d 194, 198 (Del. 1991).
312. *Id.*
313. *Id.*
314. *Id.*
315. *Id.*
316. *Id.*
317. Michael Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 476 n.50 (1992) (criticizing directors who put their own interest ahead of shareholder interests).
318. *Levine*, 591 A.2d at 205-12.
319. *See, e.g.*, Citibank, N.A. v. Data Lease Fin. Corp., 828 F.2d 686, 699 (11th Cir. 1987) ("Shareholders have the right to combine their interest and voting power to secure such control of the corporation and the adoption of and adhesion by it to specific policy and course of business.").
320. *See supra* part I.B.2 (discussing inability of shareholders to nominate directors).
321. *See Separating the Chairman and CEO*, N.Y. L.J., June 17, 1993, at 3 (commenting that shareholder dissatisfaction with corporate decisionmaking has led to structural changes in corporate governance at some corporations).

Alfred Conard, for example, has suggested that institutional investors be freed from responsibility to their beneficiaries to allow them a more active role in corporate governance.[322] Professor Bernard Black has listed a wide variety of legal constraints that need to be removed, including limitations imposed by the SEC, bank regulators, the Department of Labor under the Employee Retirement Income Security Act (ERISA),[323] and antitrust law.[324] Professors Ronald Gilson and Reinier Kraakman, among others, have supported increased reliance on independent directors as a solution to perceived corporate governance problems.[325] Professor Richard Buxbaum has made a proposal that is modeled after the two-tiered boards used in large German corporations.[326] These suggestions are merely indicative of a large and increasing number of proposals to reform corporate governance in America.[327]

Shareholders too are displeased with the existing patterns of corporate governance. Shareholders have proposed the creation of advisory committees to help get management "back on track."[328] The success of shareholder recommendations for reform also provides evidence of the growing reluctance of shareholders to allow management continued unfettered discretion in decisionmaking.[329] Share-

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322. *See, e.g.*, Alfred Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117, 119-28 (1988) (analyzing potential role of institutional investors in corporate governance).

323. 29 U.S.C. § 1001 (1989).

324. *E.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990) (calling for removal of legal constraints on shareholder participation in order to transform shareholder vote into effective means of corporate control).

325. *E.g.*, Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 865-68 (1991) (urging reform of corporate governance through increased participation by institutional investors and implementation of independent boards of directors); *see also* JAY L. LORSCH & ELIZABETH M. MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 184-87 (1989) (arguing that chairman of board should be independent director).

326. *See* Richard Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1, 2-10 (1991) (considering impact of institutional investors on corporate control in United States and Europe).

327. *See, e.g.*, Barnard, *supra* note 177, at 40 (suggesting that certain shareholders be able to nominate directors); Cane, *supra* note 184, at 60 (determining extent to which proxy regulations and case law restrain shareholder participation in corporate affairs); Dent, *supra* note 206, at 88 (proposing transfer of control of proxy solicitation from management to committee of largest shareholders); Karmel, *supra* note 205, at 55 (analyzing proper role of institutional investors in corporate governance); Lipton, *supra* note 177, at 66-69 (calling for changes in system of corporate governance in order to provide institutional investors with more control over corporate management).

328. *See, e.g.*, Barnard, *supra* note 177, at 53 n.91 (citing CalPERs proposals to shareholders of TRW, Avon Products, and Occidental Petroleum that were designed to improve management-shareholder relations and increase profitability).

329. Lorna Cox, *Investing Institutions Start To Flex Their Muscles in the U.S. Boardroom*, MULTINATIONAL BUS., Autumn 1990, at 1, 1. The author writes:

> Indeed, an increasing number of shareholders, large institutions prominent among them, are now asking unpopular questions about everything from art collections at

holder proposals on corporate governance issues have garnered dramatically increased levels of support.[330]

Widespread indications of dissatisfaction with the existing system only prove to be an underlying problem if one believes the old adage, "[w]here there's smoke, there's fire."[331] In this case, however, the absence of any effective system through which shareholders can hold management accountable causes the problems detailed in preceding sections of this Article. Given these problems, it seems desirable to explore alternatives to our current models of corporate governance.

III. WOULD INCREASED LEVELS OF SHAREHOLDER PARTICIPATION IMPROVE CORPORATE GOVERNANCE?

A. *Arguments in Favor of Reducing Barriers to Shareholder Participation in Corporate Governance*

While it can certainly be argued that greater shareholder participation in corporate governance is necessary to provide an appropriate check on directoral abuses,[332] this is only one of several possible arguments in favor of permitting large shareholders a greater role in the corporate decisionmaking process.[333] In addition to prodding

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> Occidental Petroleum at the company's expense, to the recent selection process of Mr. Smith's successor at General Motors. Generally shareholders apparently are fed up with brazen CEOs who are unaccountable . . . .

Id.

330. *Id.* at 2 ("On average there was a 36 per cent vote on shareholder corporate governance proposals, up from 7 per cent in 1986.").

331. Buxbaum, *supra* note 205, at 1733 (viewing dissatisfaction itself as problem deserving of attention and pointing out that "[i]n the long run, a private sector economy is not well served by judicial approval of institutions that erode the confidence of savers and investors"). Buxbaum's statement remains true today, where it is all too clear that our nation's economy is tied to the strength of our capital markets, which themselves depend on investor confidence.

332. *See, e.g.*, Barnard, *supra* note 177, at 91 (suggesting that directoral decisionmaking may be "less than optimal" without analyzing significance of poor decisions). Most commentators who support the idea of greater shareholder involvement in corporate governance do no more than assume that current models of corporate decisionmaking do not lead to the best decisions. Many articles in this area argue that providing a larger role for shareholders would help minimize poor decisionmaking. For example, Professor Barnard, advocating greater shareholder access to the nominating process, states: "The harm averted may include friction between capital providers and capital expenders. It may also include less than optimal modes of directoral decision making, inattention to constituency demands, and simple self-dealing." *Id.*

333. This Article focuses on greater shareholder participation by large shareholders because individuals who own a tiny fraction of a public corporation's shares cannot reasonably be expected to have the resources or economic incentives to undertake a significant role in corporate governance. Realistically, only the institutional investors and the rare large individual investor have both the resources and economic incentive to undertake significant oversight functions with regard to corporate management. *See supra* Part I.D. (describing shareholder attempts at involvement, particularly by large and institutional investors).

The precise boundaries of what constitutes a "large" shareholder are subject to debate. One alternative is to set a minimum share ownership requirement. For example, all shareholders owning more than five percent of the outstanding voting stock of a corporation, or more than

courts to overcome their inability or unwillingness to hold management to reasonable standards of fiduciary behavior,[334] a greater governing role for investors who own a significant amount of stock issued by public corporations is supported by notions of democracy because shareholders, after all, are the "owners" of the enterprise.[335] Theoretical notions of management and group dynamics also suggest

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$5 million in market value of such shares, might be presumed to have the financial wherewithal and sufficient economic incentive to participate in corporate governance. *See* Lipton, *supra* note 177, at 67-68 (proposing $5 million threshold for participation in corporate governance).

A five percent limit, at least for the largest public corporations in the United States, might be too strict. A search of the CDA/Spectrum Database reveals that at the largest U.S. companies, there are extremely few investors who have more than even one percent of the outstanding stock. Search of CDA/Spectrum Database, CDA Investment Technologies, Inc., Rockville, MD (Dec. 31, 1990) (search of 13F filings). According to the CDA Spectrum Database, at Exxon Corporation, only the College Retirement Equities Fund (1.09%), Wells Fargo (1.05%), and Bankers Trust NY Corp. (1.01%) meet this threshold. *Id.* At IBM, only Wells Fargo (1.07%), Michigan State Treasurer (1.04%), and Bankers Trust NY Corp. (1.01%) satisfy the requirement. *Id.* At General Electric, only Wells Fargo (1.09%) and Bankers Trust NY Corp. (1.02%) hold more than one percent of outstanding stock. *Id.* General Motors has six shareholders that meet this cutoff: Bernstein Sanford & Co. (2.48%), Wells Fargo (1.61%), Bankers Trust NY Corp. (1.50%), the Michigan State Treasurer (1.42%), Wellington Management Co. (1.22%), and Mellon Bank Corporation (1.06%). *Id.* Conversely, one percent might be too broad for the smallest publicly traded corporations, particularly if shareholders are allowed to aggregate their shares by forming groups.

It might thus be easier to focus on the market value of the securities, as a shareholder with a sufficiently large economic stake would be likely to have the financial ability and incentive to participate in corporate governance. As mentioned above, a $5 million threshold has been advocated by Martin Lipton:

> To promote the accountability of management, this Article proposes that the federal securities laws be amended to allow any shareholder, or group of shareholders, with more than $5 million in market value of the corporation's shares free and equal access to the corporation's proxy machinery at the corporation's expense.

Lipton, *supra* note 177, at 67.

334. *See supra* notes 75-83 and accompanying text (tracing history and impact of business judgment rule that shields directors from liability). The business judgment rule effectively insulates directors from liability for most business decisions. Courts are reluctant to substitute their own judgment for that of directors for many reasons, not all of which are questionable. *See supra* notes 82-83 and accompanying text (revealing that business judgment rule generally requires gross negligence before judicial intervention). Directors are usually more attuned to the business of their corporation than are judges, and judges often do not have the time to devote to corporate decisionmaking. Pursuant to the business judgment rule, courts do not generally hold directors accountable for bad or even negligent decisions. Consequently, shareholders must find some other way to hold directors accountable. Selling out is one way, but that is an increasingly unattractive option for large institutional investors. *See supra* notes 163-67 and accompanying text. A better solution would allow shareholders to nominate directors, and for shareholders to take a more active supervisory role.

335. *See* Cane, *supra* note 184, at 61 (explaining that shareholders, although frequently thought of as passive investors, are actual and legal owners of corporations). Currently, the only official mechanism by which shareholders can elicit management reaction is through the shareholder proposal process. *Id.* Father David Bayne, long recognized as a champion of corporate democracy, once wrote: "The day when the shareholders' meeting performed its full, democratic function, and substantially every shareholder attended, is gone. Remove the effective use of the proxy, and corporate democracy is no more." David C. Bayne, *The Basic Rationale of "Proper Subject,"* 34 U. DET. L.J. 575, 575 (1957).

potential benefits to greater investor participation.[336] Furthermore, if attentive shareholders had a cost-effective alternative to selling out or threatening litigation, then certain harmful behavior, such as high stock turnover and the corresponding pressure on management to produce a quick return, might be minimized.

1. *Directoral responsiveness to shareholder concerns*

Logically, removing barriers to shareholder participation in corporate governance should provide some balance to the lopsided jurisprudence that, in recent years, has acted to insulate directors from any meaningful degree of accountability to shareholders.[337] If backed up by a regulatory scheme permitting such involvement, the threat of increased shareholder participation might well cause management to implement sound decisionmaking processes, respond

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336. *See* IRVING L. JANIS, GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOES 9 (2d ed. 1982) (finding that overly cohesive group may strive for unanimity at expense of tolerance for different perspectives and willingness to share ideas); JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 91-95 (1990) (suggesting that dynamics of average board of directors inhibit free exchange of ideas); Walter C. Swap, *Destructive Effects of Groups on Individuals*, *in* GROUP DECISION MAKING 69-95 (Walter C. Swap et al. eds., 1984) (concluding that excessive homogeneity or cohesiveness can impair decisionmaking process).

A more balanced board may actually produce better decisions. *See* CHARLES A. ANDERSON & ROBERT N. ANTHONY, THE NEW CORPORATE DIRECTORS: INSIGHTS FOR BOARD MEMBERS AND EXECUTIVES 90 (1986) (advocating balance of occupation, experience, age, gender, race, and geographical representation for board members); Barnard, *supra* note 177, at 77 ("These behavioral patterns can ultimately lead to an institutional inability to challenge the management-delivered view of corporate affairs and a resulting failure of the board to exercise sound and independent business judgment."). A balanced board seems particularly appropriate as traditionally selected boards tend to be hesitant to take the steps necessary to ensure independent decisionmaking. *See* MYLES L. MACE, DIRECTORS: MYTH AND REALITY 52-53 (1986) (reporting that outside directors are more likely than inside management to ask challenging and discerning questions during board meetings and to promote debate that leads to better decisionmaking). Mace's study concluded that even a minimal number of outside directors can stimulate independent thinking. *Id.* at 64.

337. Various methods have been used to exclude shareholders from participation in corporate decisionmaking. Some states have enacted legislation permitting management to bypass certain shareholders in making decisions concerning business combinations. *See, e.g.*, DEL. CODE. ANN. tit. 8, §§ 203(a)(2), 203(c)(5) (1991); N.Y. BUS. CORP. LAW § 912 (McKinney 1986). One recent study identified 28 jurisdictions with such legislation. *See* John H. Matheson & Brent A. Olsen, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425 app. at 1521-29 (1991). Other state statutes minimize shareholder voting rights for "control shares." *Id.* at 1533-37 (identifying 27 states with control share legislation). Other states have empowered directors to consider interests other than those of shareholders. *See Symposium: Corporate Malaise—Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 1 app. at 279-93 (1991) (listing 28 state statutes that allow directors to consider, for example, community or societal needs in addition to those of corporation).

Nor are statutes the only method used to relegate shareholders to a smaller role in corporate governance. Judicial decisions have also acted to tip the scales in favor of management. *See* John H. Matheson & Brent A. Olsen, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1347-53 (1992) (describing recent decisional law limiting director accountability to shareholders).

to informally expressed shareholder concerns, and avoid transactions tainted by self-interest.

Such changes would represent a significant departure from recent trends, which have generally provided directors with more discretion and less accountability. State legislatures have adopted an incredible variety of extremely promanagement statutes, and state courts have eagerly embraced a very expansive view of the business judgment rule.[338] In fact, the business judgment rule has become a shield of immense proportions, preventing claims against directors from succeeding in the vast majority of cases.[339] Even without a significant shift in actual shareholder behavior, amending federal regulations and state provisions affecting shareholder participation in governance might well have a salutary effect on management behavior.

We can only speculate as to whether shareholder behavior might change in such a way as to cause changes in corporate decisionmaking. Evidence that large shareholders seem ready to assume a greater role in corporate governance[340] is insufficient to ensure that they will in fact assume such a role if the opportunity is provided. Similarly, evidence that shareholders have not successfully imposed their views on management in the past is no indication that shareholders will never succeed in such an endeavor.[341]

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338. *See supra* notes 71-73, 84-92 and accompanying text (discussing recent trends related to director liability and increased exclusion of shareholders from management of corporate affairs).

339. *See supra* notes 73-82 and accompanying text (discussing business judgment rule).

340. *See supra* Part I.D (discussing attempts at shareholder activism, particularly by institutional investors).

341. *See supra* Part II.B (finding that substantial barriers to shareholder access to corporate proxy machinery adequately explain shareholders' inability to influence management decisions). Currently, no procedural and regulatory limits exist for informal communications between shareholders and management. It would seem then, that shareholders could communicate with management outside of the cumbersome arena of proxy solicitations. It has been suggested that the failure of shareholders to take advantage of such informal communications indicates a lack of commitment by shareholders. *But see* Barnard, *supra* note 177, at 79-81 (citing lack of incentives and high cost of participation, rather than lack of commitment, as cause of shareholder passivity, but noting current trend away from apathy).

It is management, however, that appears to have prevented this approach from becoming a meaningful avenue of participation in decisionmaking. *See supra* parts I.D, II.A (discussing shareholder attempts at activism and management pursuit of self-interest). First, there is little incentive for management to change its policies merely because a shareholder makes an informal request. Second, there is no reason to believe that the majority of corporations have any structure for responding to informal shareholder requests.

In addition to informal channels of communication, one commentator has suggested that the rule allowing shareholder proposals is a far less efficient means of communication than the informational clues and incentives presented to management via the capital markets. *See* George W. Dent, Jr., *SEC Rule 14a-8: A Study in Regulatory Failure*, 30 N.Y.L. SCH. L. REV. 1, 31-38 (1985) (contending that management can use capital markets to determine whether large groups of shareholders are so dissatisfied with corporation's performance that they have decided to sell out). Dent also notes, however, that it will often be difficult, if not impossible, for management

To date, legislatures and courts have never really given shareholders in public corporations a meaningful opportunity to participate in corporate decisionmaking. It is ironic that as institutional investors, who have the financial and practical resources necessary to participate meaningfully in corporate governance, become more prominent, obstacles to their participation in corporate decisionmaking have also proliferated.[342] When regulatory obstacles were at a minimum, shareholders generally lacked the practical ability to monitor or participate in corporate management.[343] Now that practical limitations have receded, regulatory obstacles have come to the forefront to prevent meaningful involvement.[344]

It is true that we do not know whether giving shareholders the opportunity to participate in corporate governance will actually result in such participation at a significant level. The current system, however, is unbalanced and subject to abuses. Further, there is some indication that many institutional investors are in fact ready and willing to assume a greater role in corporate governance.[345] The time has come, therefore, to implement changes that will allow shareholders to participate more actively in corporate governance.

2. *Corporate democracy*

To the extent that the preceding argument may be deemed unpersuasive, there are other reasons to provide shareholders with greater access to corporate decisionmaking. The potential benefits of increased shareholder access do not all assume or require that all eligible shareholders will become intimately involved in the governance of public corporations. The theoretical ideal of corporate democracy, for example, does not require that shareholders exercise their rights; it merely requires that shareholders have the opportunity to participate.[346]

Technically, at least, shareholders are the owners of corporations

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to tell exactly what prompted the decision to sell. *Id.*

342. *See* Conard, *supra* note 322, at 155-63 (illustrating obstacles encountered by institutional investors, such as "emptiness of shareholder rights," liability of investors deemed to be "controlling" by exercising rights, and group filing requirements).

343. Conard, *supra* note 322, at 126-30.

344. *See supra* part I.B (describing barriers to shareholder participation in corporate governance).

345. *See* Conard, *supra* note 322, at 152-63 (considering emerging presence of institutional investors and potential effect on role of shareholders in corporate governance); *see also supra* part I.D (describing shareholder attempts at participation).

346. For example, the United States is still considered a democracy, even though the voter turnout in most elections is far below 50% of the eligible population. *See* Jeanne Williams, *School Voucher Initiative*, L.A. TIMES, Aug. 27, 1993, at B6 (reporting 50% voter turnout at presidential elections).

in which they have invested. State statutes carefully establish the rights of shareholders to control major life changes of the corporations in which they have an equity interest.[347] These statutes also carefully establish shareholders as the parties who have the right to elect the directors who control day-to-day operations.[348] Nothing in the federal statutes or regulations changes this basic allocation of power to shareholders. How, then, can shareholders in public corporations claim that they have been effectively disenfranchised?[349]

The answer to this question is found by examining the mechanics of corporate governance. Yes, shareholders have the right to "elect" directors, but they have no effective way of nominating them.[350] Shareholders can stage a proxy fight if they want to elect an opposing slate of directors, but this is an incredibly expensive process, particularly for shareholders who really only want to replace one or two management nominees with new candidates.[351] In reality, then, the right to "elect" directors in American corporations becomes no more meaningful, and no more democratic, than elections in totalitarian states where the government hosts "elections" with only one "candidate" for each of the public offices to be filled.[352]

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347. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 109, 141(k), 211(b), 242, 251, 271, 275 (1991) (setting forth shareholder voting rights, removal of directors, election of directors, charter amendments, mergers, sale of assets, and dissolution).

348. *See supra* notes 56-57 and accompanying text (discussing how state statutes give shareholders right to elect directors, who, in turn, manage corporations); *see also* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 531-32 (1990) (identifying matters on which shareholders generally vote under state law).

349. Only shareholders in public corporations claim to have been disenfranchised. In close corporations, where the directors are typically themselves shareholders, there is generally no problem with self-perpetuating boards that are insulated from shareholder concerns. In most close corporations, the shareholders play a significant role in management. *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 511, 515 (Mass. 1975) (drawing analogy between fiducial obligations of partners in partnership and those of stockholders in close corporation).

Moreover, in a small corporation, it is not impractical for the shareholders to get together and arrange an ouster of inattentive directors. *See id.* Although minority shareholders in close corporations often complain about having been "frozen out" of their corporations, it is other shareholders who typically arrange for minority shareholders to be cut off. *See id.* As a group, shareholders in close corporations have a meaningful level of control that is generally commensurate with their ownership in the corporation.

350. *See supra* part I.B.2 (discussing ways in which current proxy rules exclude shareholders from nomination process and indicating that such exclusion precludes real shareholder choice in elections); *see also* Lowenstein, *supra* note 154, at 2 (explaining that "there was no substance to process" of allowing shareholders to elect directors). Lowenstein added that "[m]anagement had picked the candidates beforehand, and over 99 percent of the time there was no opposition slate." *Id.*

351. *See* Barry J. Sobering, Comment, *Shareholder Democracy: A Description and Critical Analysis of the Proxy System*, 60 N.C. L. REV. 145, 159-60 (1981) (discussing prohibitive costs associated with proxy contests).

352. *See* Barnard, *supra* note 177, at 39 (comparing American corporate elections to elections in North Korea to demonstrate lack of democratic choice in corporate elections).

With regard to matters other than election of directors, there are similar regulatory provisions purporting to grant shareholders access to the decisionmaking process. As a matter of federal law, shareholders can solicit proxies at their own expense[353] or force the corporation to include shareholder proposals in corporate proxy materials at the corporation's expense.[354] These provisions may seem to provide fair access to the decisionmaking process. After all, if shareholders can solicit their own proxies and make their own proposals, then it does not appear as if they have been unfairly silenced. Unfortunately, just as with the apparent right to "elect" directors, access to the proxy machinery is often more apparent than real.

Federal law generally requires certain disclosures that must accompany any proxy solicitation.[355] Although the disclosures are somewhat burdensome, the SEC screening process for proposed proxy solicitations is even more of a barrier to shareholder communication.[356] To some extent, the 1992 amendments to the proxy rules have made the review process less burdensome for most shareholders. Prior to these amendments, all communications relating to proxies had to be prefiled with the SEC.[357] The 1992 amendments exempt communications by most shareholders[358] not seeking proxy authority from the regular prefiling requirements,[359] but impose a special notice requirement for written solicitations by beneficial owners of securities having a market value in excess of $5 million.[360] At this time, the exact process by which the SEC will review filings under the new rules is still uncertain. The right of large shareholders to

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353. *See* 17 C.F.R. § 240.14a-7 (1993).

354. *See id.* § 240.14a-8.

355. *See id.* § 240.14a-101. While additional items must be disclosed, a soliciting shareholder may incorporate by reference any material that appears in the company's proxy statement. *Id.* § 240.14a-7.

356. *See* Black, *supra* note 348, at 536-42 (discussing costs and risks of shareholder communication due to proxy rules); Conard, *supra* note 322, at 117 (positing that proxy rules hinder rather than encourage shareholder involvement); Nell Minow, *Proxy Reform: The Case for Increased Shareholder Communication*, 17 J. CORP. L. 149, 155 n.20 (1991) (arguing that current SEC proxy rules inhibit stockholder communication); John Pound, *Proxy Contests, The SEC Rewrites the Rules*, AM. ENTERPRISE, Sept.-Oct. 1991, at 58, 58-59 (arguing that current SEC proxy rules deter "free speech and efficient communication" among shareholders).

357. 17 C.F.R. § 240.14a-6 (1986).

358. *Id.* § 240.14(a)-2(b) (excluding registrant, any affiliate, any officer or director if solicitation is financed by registrant, any nominee for election as director, and certain other persons from exemption to prefiling rules).

359. *See* Regulation of Communications Among Shareholders, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051 (Oct. 16, 1992) (reporting amendments to proxy rules). The particular amendment dealing with the exemption from prefiling is codified at 17 C.F.R. § 240.14a-2(b) (1992).

360. 17 C.F.R. § 240.14a-6(g)(1) (1992). This notice requirement does not apply to oral solicitations, speeches delivered in a public forum, or information appearing in broadcast media, newspapers, magazines, or bona fide publications. *Id.* § 240.14a-6(g)(2).

communicate with other shareholders on matters of grave importance to shareholders is thus compromised by the existing federal regulations.

Perhaps more important, at least from a corporate democracy standpoint, there are other substantial obstacles to shareholder participation in corporate governance through the proxy process. As is more fully described elsewhere in this Article, shareholders face numerous regulatory obstacles in trying to participate in the proxy process.[361] There are, for example, numerous topics that shareholders are not permitted to raise in proxy proposals.[362] Furthermore, shareholders must limit the supporting statements for their proposals to 500 words, while management is not limited in the length of its response.[363] Finally, shareholders have no way to communicate with other shareholders outside of the proxy process, which is controlled and scrutinized by the corporation.[364]

In fact, the voting process in most corporations is not confidential.[365] Management is generally free to screen proxies and to communicate with recalcitrant shareholders.[366] Shareholders always face the possibility of retaliation by management on future decisions, a fact of which many shareholders are well aware.[367] Management

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361. *See supra* part I.B (criticizing barriers to shareholder participation in corporate governance, including directoral dominance and exclusion of shareholders from director nominations process).

362. 17 C.F.R. § 240.14a-8 (1993). The shareholder proposal rules expressly permit corporate management to exclude from consideration any shareholder proposals relating to election to office, ordinary business matters, anything that is the subject of another resolution, or matters that are not "significant" to the corporation. *Id.* § 240.14a-8(c).

363. *Id.* § 240.14a-8(b)(1).

364. For example, federal law does *not* require that the corporation supply the shareholders with a list of other shareholders. Even under the provision that allows shareholders to conduct mailings at their own expense, the corporation has the right to choose whether to allow the shareholder access to the shareholder list or make the mailings on the shareholder's behalf. *Id.* § 240.14a-7c.

State law frequently provides some access to shareholder lists, but only at limited times and only for a proper purpose. *E.g.*, DEL. CODE ANN. tit. 8, § 219(a) (1991) (requiring that officer of corporation prepare shareholder list and have it available for inspection "at least 10 days before every meeting of stockholders"). Because this 10-day timeframe is completely inadequate to allow communication between shareholders, this obligation is essentially meaningless in the context of proxy solicitations. If the corporation refuses to provide a shareholder list in a timely fashion, the shareholder can seek judicial relief, although such relief would almost certainly not be granted in time for the shareholder to make an effective mailing prior to a particular meeting. *See* Rainbow Navigation, Inc. v. Pan Ocean Navigation, Inc., 535 A.2d 1357, 1359 (Del. 1987) (holding that "statutorily guaranteed right to examine the stock ledger cannot be frustrated by nonfeasance").

365. *See supra* notes 132-35 and accompanying text (discussing fact that most boards of directors have access to proxies prior to vote and such proxies are not kept confidential).

366. *See supra* notes 134-35 and accompanying text (reporting results of IRRC Survey that revealed pre-vote contact between directors and voting shareholders is not uncommon).

367. *See* MCGURN, *supra* note 133, at 53-78 (presenting detailed discussion of comments by shareholders that express their fear of retaliation).

can even conduct resolicitations in the rare cases where the process has not given management enough of an edge.[368]

Consequently, shareholders in public corporations, although technically the owners of the corporation, have no meaningful say in how the corporation is run. They cannot change directors or corporate policies. They can only change their investment, and they can only do that if transaction costs are not too high and a suitable replacement exists. Such a model does not fit well with notions of corporate democracy and shareholder suffrage.

3. Improved group dynamics

Of course, to the extent that shareholders do choose to participate in corporate governance, there may be additional advantages. Certainly it is not unreasonable to expect that the presence of shareholder nominees on the board would have some impact on directoral abuses. Indeed, the ALI's suggested model for corporate governance relies heavily on "outside" directors as a check on management abuses.[369] The ALI report suggests, for example, that every large publicly held corporation's board[370] have a majority of outside directors[371] and independent audit,[372] nominating,[373]

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368. *See infra* notes 492-95 and accompanying text (contending that shareholders feel threatened by management).

369. *See* ALI, CORPORATE GOVERNANCE, *supra* note 9, part III-A, at 143-74 (recommending that directors should not have any "significant relationship" with senior executives of corporation). The term "significant relationship" includes any director who is employed by the corporation, was employed within the *two* previous years, has an immediate family member who fits either of these tests, "has made to or received from the corporation during either of its two preceding years, commercial payments exceeding $200,000," or "is affiliated in a professional capacity with a law firm that was the primary legal adviser to the corporation with respect to general corporate or securities law matters . . . within the two preceding years." *Id.* § 1.34, at 42-44.

370. *See* ALI, CORPORATE GOVERNANCE, *supra* note 9, § 1.24 (defining "large publicly held corporation" as corporation that had 2000 or more record holders of equity securities and over $100 million in total assets).

371. ALI, CORPORATE GOVERNANCE, *supra* note 9, § 3A.01(a). It is not unusual to see such emphasis placed on outside directors. In fact, the comments to this section of the report note that the New York Stock Exchange, NASDAQ, and the American Stock Exchange all recommend a minimum of two independent directors. *Id.*

372. ALI, CORPORATE GOVERNANCE, *supra* note 9, § 3A.02. The ALI proposal recommends that the independent audit committee be composed exclusively of outside directors. *Id.*

373. ALI, CORPORATE GOVERNANCE, *supra* note 9, § 3A.04. This proposal suggests a nominating committee composed entirely of directors who are not officers or employees, and a majority of whom have no significant relationship with the corporation's senior executives. *Id.* The efficacy of nominating committees in assuring independent decisionmaking is, however, subject to doubt. Even when a nominating committee is employed to choose new directors, the CEO tends to dominate the selection process. *See* HEIDRICK & STRUGGLES, THE CHANGING BOARD 4 (1983); John Perham, *The Men Who Pick the Board*, DUNS REV., Dec. 1978, at 57 (summarizing three general types of nominating committees and roles of CEO in each model).

and compensation committees.[374]

While these recommendations evidence a certain degree of faith in outside influences as a curb against directoral abuses, the ALI model falls short of the goal of providing truly independent directors. If adopted, the ALI recommendations would operate in a system where outside directors are nominated by directors approved and appointed by existing management.[375] Management is likely to select directors who are compatible with other directors and likely to agree with management suggestions.[376] Outside directors chosen in such a manner are unlikely to change the dynamics of board behavior.[377]

If outside directors disagree with management during their tenure on the board, management might not nominate them again, and, short of a major proxy contest, shareholders would have no effective means by which to lobby for their retention. Shareholders do not even have the power to include nonbinding resolutions of support for particular candidates in the proxy materials because such resolutions would relate to election to office, and management can exclude them under current shareholder proposal rules.[378]

If shareholders were given the power to exercise direct control over the nominating process, management would always know that shareholders could step in if the insiders go too far in selecting passive outside directors. The deterrent effect of such provisions should not be overlooked. Moreover, if shareholders had the power to nominate their own candidates, they could in fact exercise that power. In that case, shareholders would presumably select candidates

374. ALI, CORPORATE GOVERNANCE, *supra* note 9, § 3A.05.

375. *See supra* part I.B.2 (discussing exclusion of shareholders from directoral nomination process).

376. *See* JEREMY BACON & JAMES K. BROWN, CORPORATE DIRECTORSHIP PRACTICE: ROLE, SELECTION AND LEGAL STATUS OF THE BOARD 30 (1975) (finding that personal compatibility with CEO and genuine interest in company are typically requirements for outside directors); MACE, *supra* note 336, at 97-101 (stating that when outside directors are chosen by current management, factors considered include friendliness, relationship to current management, and propensity for avoiding conflict or creating discord); James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 91 (1985) (stating that "the leading criterion for selecting a board nominee is his probable identification with and acceptance of the company's goals and methods of operation"); *see also* Michael P. Allen, *Economic Interest Groups and the Corporate Elite Structure*, 58 SOC. SCI. Q. 597, 607 (1978) (defining "interlocking corporations" as those with one or more directors in common, and identifying interlocking corporations that create geographical and financial interest groups due to close relations between members of management); Thomas Koenig et al., *Models of the Significance of Interlocking Corporate Directorates*, 38 AM. J. ECON. & SOC. 173, 178-79 (1979) (describing "interlock replacement patterns" in modern corporations).

377. *See* Cox & Munsinger, *supra* note 376, at 85-108 (discussing psychological foundations of directoral decisionmaking and concluding that even independent directors succumb to managerial bias).

378. 17 C.F.R. 240.14a-8(c)(8) (1993).

with an eye toward safeguarding shareholder concerns.

One commentator has stated that a board of directors is most likely to perform its functions well "when important stockholders are holding a prod to its collective back."[379] Because directors have the legal right to manage their corporations,[380] and because the business judgment rule effectively shields directors from liability for even negligent mismanagement,[381] the only meaningful way to ensure optimal decisionmaking by the board is to give shareholders the right to replace directors who fail to live up to shareholder expectations with shareholder nominees.

4. *An alternative to the Wall Street Rule*

Many commentators have bemoaned the high rates of turnover apparently favored by modern investors.[382] Short-term investing has been blamed for a number of problems, ranging from pressures on the board to make policy decisions that are counterproductive in the long run, to pressures for high rates of return that make business failures more likely.[383] Management and promanagement commentators have been particularly vehement about the dangers associated with the high turnover of stocks.[384] Yet many of these same promanagement voices also praise the Wall Street Rule and market forces as appropriate devices for controlling management abuses.[385]

Under the Wall Street Rule, investors who are dissatisfied with management are supposed to turn to Wall Street for a solution to their woes. In other words, if they become dissatisfied with the management of a particular enterprise, they should sell their shares in that company and invest in another business that has better management. It is ironic that this "market solution" contributes to

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379. Barnard, *supra* note 175, at 1135-36.

380. *See supra* note 56 (citing state statutes that give directors authority to manage affairs of corporation).

381. *See supra* notes 75-82 and accompanying text (discussing business judgment rule).

382. *See, e.g.*, Richard R. Ellsworth, *Capital Markets and Competitive Decline*, HARV. BUS. REV., Sept.-Oct. 1985, at 171, 172 (noting that corporate strategies designed to produce short-term returns to investors interfere with corporations' ability to compete in international market and to produce long-term returns); Lipton, *supra* note 177, at 7-9 (criticizing institutional investors, who are viewed as seeking immediate profits, for wave of highly leveraged takeovers); Lowenstein, *Stockholders, Humbug!*, *supra* note 169, at B1 (noting that during past 10 years, corporate takeovers and buybacks have been aimed at promoting shareholders' short-term interests).

383. *See supra* notes 163-67 and accompanying text.

384. *See supra* notes 163-67 and accompanying text.

385. *See supra* notes 163-67 and accompanying text.

the turnover of stock ownership.[386]

Providing shareholders with a meaningful role in corporate governance may well serve to minimize at least some of the pressures that encourage the high turnover of stock. Instead of leaving dissatisfied shareholders with no meaningful option other than selling their shares, new corporate governance rules would provide shareholders with the option of contesting management's decisions. If regulations were amended to allow shareholders a greater role in corporate governance, they could nominate directors with competing views, or could propose resolutions to oppose particular policies. In either event, shareholders would have more meaningful options than selling out and moving on.

B. *Potential Problems with Reducing Barriers to Shareholder Participation*

Not surprisingly, just as numerous commentators have proposed changes to allow shareholders a greater role in corporate decisionmaking,[387] other commentators have raised a number of objections to such proposals.[388] The objection that is repeated most often is that greater access would result in a waste of management and corporate resources. Regardless of whether the suggested reform is designed to promote shareholder proposals, shareholder participation in the directoral nominating process, or otherwise, critics generally respond by describing shareholders as apathetic and unlikely

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386. *See supra* note 199 (discussing short-termism and high-turnover-associated market forces). Of course, the market solution also overlooks transaction costs and the very real possibility that it may be exceedingly difficult for investors to locate appropriate investments with better management.

387. *See, e.g.*, Conard, *supra* note 322, at 163-76 (discussing positive consequences of increased shareholder activity, including higher profits, fewer resources wasted on takeovers, deterrence of inappropriate managerial compensation, and prevention of shareholder suits); Thomas M. Jones, *Corporate Governance: Who Controls the Large Corporation?*, 30 HASTINGS L.J. 1266, 1280-85 (1979) (concluding that despite shareholder voting power, lack of incentives and political resources prevents effective change in dominance of management); Robert B. Reich, *Corporate Accountability and Regulatory Reform*, 8 HOFSTRA L. REV. 5, 31-37 (1979) (proposing reforms in collective decisionmaking processes and improvements on market exchanges as solutions to corporate management problems).

388. *See, e.g.*, Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980) (proposing that separation of ownership from control is "efficient form of economic organization" and that competition from other organizations disciplines those in control); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982) (challenging argument that traditional corporate governance models are inappropriate and problematic, and criticizing movement toward increased shareholder participation); Homer Kripke, *The SEC, Corporate Governance and the Real Issues*, 36 BUS. LAW. 173, 175-78 (1981) (noting that efforts to revive corporate democracy are futile because shareholders do not consider themselves partial owners, but rather holders of investment contracts with corporation, with no incentive to monitor corporation's actions).

to participate even if given the opportunity to do so.[389] When discussing reforms designed to remove barriers to shareholder proposals, promanagement commentators typically contend that such reforms would prove ineffective because most shareholder initiatives fail.[390] With regard to proposals to allow shareholders access to the directoral nominating process, management often contends that shareholder candidates would not be elected, and if they were, such candidates would impair efficient decisionmaking.[391] It has also been suggested by management that shareholder candidates would recognize only short-term interests,[392] that the market for corporate control is a better mechanism for dealing with poor management,[393] and that allowing institutional investors to nominate directors may harm the investors' beneficiaries.[394]

There are a number of possible responses to most of these objections. One can assert both theoretical and practical responses to the argument that reforms are a waste of time because shareholders are apathetic and would not take advantage of the opportunity to make or support shareholder proposals. Theoretically, any prediction based on past shareholder behavior is valid only if one postulates the continuation of existing barriers to shareholder participation. In fact, the argument that reforms removing barriers to shareholder proposals will waste management time because shareholder initiatives fail under the current regime is utterly circular.

It is true that most shareholder initiatives enjoy little success at the

389. *See, e.g.*, Barnard, *supra* note 177, at 79 (citing lack of economic incentives, costs outweighing benefits, and free-rider risks as causes of shareholder apathy and passivity); Henry G. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1440-41 (1964) (explaining that costs outweigh benefits of shareholder proxy solicitations and therefore shareholder opportunities for participation in corporate governance are wasted).

390. *See, e.g.*, Barnard, *supra* note 177, at 75 (noting that SEC's pre-1990 position against shareholder proposals changed as such proposals encountered more success); William J. Feis, *Is Shareholder Democracy Attainable?*, 31 BUS. LAW. 621, 640 (1976) (arguing that shareholder initiatives fail because too few shareholders participate in process); Sobering, *supra* note 351, at 164 (observing that use of shareholder initiatives to install shareholder nominees has been ineffective because such proposals rarely garner majority of vote).

391. *See* Barnard, *supra* note 177, at 76-79 (discussing argument that diversified board is likely to be ineffective decisionmaking body).

392. *See* Reich, *supra* note 387, at 26-28 (1979) (suggesting separation of shareholders from decisionmakers as solution to corporate focus on short-term considerations).

393. *See* Barnard, *supra* note 177, at 84-86 (offering rebuttal to conventional wisdom of Wall Street Rule). The phrase "market for corporate control" refers to the notion that when a company is poorly managed, it will be under-valued, and thus more vulnerable to being taken over by new owners. Assuming the new owners acquire enough of an interest to place them in effective control, they can replace existing management and thereby presumably increase efficiency and the value of the company.

394. *See* Barnard, *supra* note 177, at 88-89 (rebutting common objections that empowering institutional investors will subject their beneficiaries to liability as "controlling" persons, or to "short swing trading" liability under SEC proxy rules).

present time, at least when success is measured in terms of how many of these proposals are adopted over management opposition.[395] This pattern, however, would not necessarily continue if the numerous barriers to the success of such measures were removed. In fact, the failure rate is just as easily advanced as a reason why reform is necessary. Without reform, shareholder proposals do not succeed; with reform, they may prevail.[396]

With regard to the objections specifically targeted toward shareholder candidates for directoral positions, there are again a number of responses. The objection that any reform is a waste of time because shareholders will never elect candidates opposed by management can be dismissed as unsubstantiated speculation. The fact that in the past shareholders have elected so few shareholder candidates over management opposition is readily explainable by the variety of procedural and substantive barriers that currently limit a shareholder's rights to pursue such nominations.[397]

Moreover, if allowing shareholders to propose nominees will not go far enough toward establishing shareholder suffrage, additional steps can be taken. For example, it is possible to structure the system so that a certain percentage of directoral seats are *reserved* for shareholder nominees. If shareholders do not nominate candidates to the designated shareholder seats, then management could select nominees for the seats. Under such a system, the argument that reform would waste time because shareholder nominees would never be elected is rendered moot. If the election process is set up in such a way that it will affect the ultimate selection of board members, then opponents to such reform cannot dismiss the idea as a waste of time and resources solely because they do not believe that it will result in the election of shareholder nominees.[398]

Opponents to reform also object that shareholder candidates will waste management resources if elected. It is not at all clear, however, that shareholder candidates would in fact "waste" time. There is

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395. *See* Cane, *supra* note 184, at 59-62 (presenting types and numbers of proposals excluded under current proxy rules).

396. This is, of course, precisely as circular as the reasoning of promanagement commentators. Earlier sections of this Article, however, present additional reasons why reform is necessary; the Article does not rely solely on this circular rationale.

397. *See supra* part I.B.2 (discussing obstacles to shareholder participation in corporate democracy).

398. Of course, such extreme actions may not be necessary. Just as the "failure" rate of shareholder proposals under the current system is no guarantee that they would continue to fail under a different regulatory regime, the fact that shareholder candidates have not fared well in the past is no real evidence that this pattern would continue if shareholders had any meaningful access to the nomination process.

theoretical evidence[399] that directors nominated by shareholders and dependant on shareholders for renomination could improve decisionmaking at the board level.[400] Such evidence comes principally from studies of group dynamics and group decisionmaking.[401] For example, studies suggest that the presence of active participants who are willing to question data and proposed conclusions generally leads to better decisions.[402] Similarly, other studies have found that involving outsiders in the decisionmaking process helps produce optimum results.[403]

At the current time, the typical board of directors operates in a way designed to preclude outside participation and probative questioning. Traditional board members are chosen because they are likely to agree with management and other board members, and to abide by conventions that overvalue the opinions of the CEO and minimize expression of alternate options or opinions.[404] Because of the structure of the typical board of directors, there is seldom any real discussion on policy decisions.[405] This system is not the optimum structure or process for complex decisionmaking.

Moreover, it is difficult to defend the position that outside directors will negatively affect the operation of corporate directors when the current system is substantially premised on the value of outside directors. The presence of outside directors, for example, is often cited as a reason why directors' decisions are considered presumptive-

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399. Empirical evidence of the success of shareholder nominees in American corporations does not exist because the model of corporate governance in America effectively precludes shareholders from nominating competing directors, unless they are seeking to replace the entire board.

400. *See* MACE, *supra* note 336, at 104-05 (concluding that shareholder nominees would be more likely to spark debate that will improve decisions in long-run); Barnard, *supra* note 177, at 76-79 (arguing that shareholder-elected directors would create more diverse group of management resulting in improved decisionmaking).

401. *See* JANIS, *supra* note 336, at 262-71 (recommending outside directors as one solution to problem of "groupthink" in corporations); Michael R. Callaway et al., *Effects of Dominance on Group Decision Making: Toward a Stress-Reduction Explanation of Groupthink*, 49 J. PERS. & SOC. PSYCHOL. 949, 952 (1985) (concluding that groups whose members have predisposition toward arguing for their own point of view are likely to reach high-quality decisions); Mann & Janis, *Decisional Conflict in Organizations*, *in* PRODUCTIVE CONFLICT MANAGEMENT: PERSPECTIVES FOR ORGANIZATIONS 21, 37-38 (D. Tjosvold & D. Johnson eds., 1983).

402. *See* Callaway et al., *supra* note 401, at 950-52.

403. *See* JANIS, *supra* note 336, at 262-71; Mann & Janis, *supra* note 401.

404. *See* C. WRIGHT MILLS, THE POWER ELITE 11-12, 122-30 (1963) (defining "people of higher circles" as separate and compact class and asserting that CEOs at America's largest corporations control who may and may not enter their circle); Elmer W. Johnson, *An Insider's Call for Outside Directors*, HARV. BUS. REV., Mar.-Apr. 1990, at 47, 47 (describing "control mentality" of CEOs in corporate management selection process in light of experience as director on GM board).

405. *See* Johnson, *supra* note 404, at 47.

ly reasonable under the business judgment rule.[406] Furthermore, the presence of outside directors is often deemed significant by courts reviewing a board's recommendation to dismiss a derivative action.[407] After more than a decade of study, the ALI project on corporate governance advocates significantly increased reliance on outside directors, particularly regarding decisions on nominations and compensation.[408] The objection that shareholder candidates will prevent the board of directors from functioning properly thus seems contradicted by the overwhelming theoretical support that exists for outside directors.[409]

The studies on the practical effect of outside directors are somewhat mixed. Many commentators have suggested that, when outsiders are chosen by incumbent directors, there is no real difference in corporate decisionmaking.[410] This result is not particularly surprising considering that these outsiders are chosen precisely because they are likely to agree with existing policies and procedures.[411] Nonetheless, one might expect some small degree of improvement in decisionmaking with outside directors. Even if outsiders are closely linked to management, at least they are more likely to remain

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406. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 294 (7th Cir.) ("The presumption of good faith the business judgment rule affords is heightened when the majority of the board consists of independent outside directors."), *cert. denied*, 454 U.S. 1092 (1981); Wharshaw v. Calhoun, 221 A.2d 487, 492-93 (Del. 1966) (noting that directors' actions are presumed to have been taken in good faith and that plaintiff therefore bears burden of proving improper motives or relations to group benefitted by particular decision); Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971) (indicating that separation or independence from transaction requires deference to sound business judgment).

407. *See, e.g.*, Burks v. Lasker, 441 U.S. 471, 485 (1979) (holding that by enacting ICA, Congress intended independent directors to determine whether to terminate derivative action, even though not frivolous, and that courts should defer to that judgment); Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 275 (3d Cir. 1978) (holding that court's decision to defer to director's business judgment must be based on good faith and independence of director), *cert. denied*, 439 U.S. 1129 (1979).

408. ALI, CORPORATE GOVERNANCE, *supra* note 9, §§ 3A.04, 3A.05; *see also supra* notes 369-74 and accompanying text (using ALI recommendations as example of prevalence of view that outside directors can perform important corporate governance function).

409. *See* ALI, CORPORATE GOVERNANCE, *supra* note 9, at 145 (noting that even Business Roundtable endorses board structure composed principally of outside directors).

410. *See, e.g.*, Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 611-13 (1982) (suggesting that independent directors are not particularly successful because they share cultural values with management and lack resources and adequate incentives); Conard, *supra* note 322, at 129 (concluding that current independent directors are tied so closely to management that "[t]hey will support almost anything that the executives propose," and "will resign in extreme cases rather than oppose the executives who invited them on the board"); Lewis D. Solomon, *Restructuring the Corporate Board of Directors: Fond Hope—Faint Promise?*, 76 MICH. L. REV. 581, 593-600 (1978) (presenting results of empirical review of corporate board performance indicating insignificant changes in decisions or approach to governance after implementation of court-imposed changes in structure, including use of outside directors).

411. *See* Brudney, *supra* note 410, at 611-13; Conard, *supra* note 322, at 129.

objective than management itself. In fact, some studies do reflect minor improvements in decisionmaking as the percentage of outsiders increases.[412] Thus, while outside directors chosen by management are not a panacea for the problems facing American corporations, they are at worst a benign influence, and outside directors chosen directly by shareholders might provoke the board to render even more responsive and effective decisions.

Opponents to increased shareholder influence also argue that shareholder-nominated directors are likely to have only short-term interests at heart.[413] Current directors, however, are already accused of concentrating on short-term concerns;[414] there is little reason to believe that adding shareholder candidates to the boards of directors of American corporations would increase the focus on short-term concerns.[415] In fact, as shareholders are given greater incentives to stay on for the long run, the presence of shareholder candidates may result in greater long-term vision. Moreover, once directors are elected, regardless of who nominated them, they become fiduciaries of the corporation, and shareholders' candidates should have no more reason to focus on short-term interests than other directors.[416]

Finally, some critics contend that "an uninhibited market for corporate control" is a more efficient mechanism for correcting poor performance by management.[417] Practical considerations, however,

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412. *See, e.g.*, Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. ECON. & ORG. 101, 104, 121 (1985) (finding that increasing number of outside directors has mild positive effect on organizational performance); Idalene F. Kesner & Roy B. Johnson, *An Investigation of the Relationship Between Board Composition and Stockholder Suits*, 11 STRATEGIC MGMT. J. 327, 333 (1990) (concluding that boards with higher percentages of outsiders are sued less often for breaches of fiduciary duty than those with more insiders).

413. *See* Lipton, *supra* note 177, at 7-9 (commenting on short-term goals of newly empowered institutional investors); Lowenstein, *Stockholders, Humbug!*, *supra* note 169, at B1 (noting current trend toward optimizing shareholder returns); Reich, *supra* note 387, at 26 (arguing that increased shareholder participation through collective decisionmaking may be dominated by short-term concerns at expense of long-term policy).

414. *See* BRYAN BURROUGHS & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO 4-5 (1990) (detailing preoccupation of CEO Ross Johnson and RJR board with "undervalued" stock prices and improving quarterly financial figures); LORSCH, *supra* note 336, at 188 (maintaining that corporate leaders make decisions that affect entire economy and therefore should focus on long-term rather than short-term interests).

415. *See* Barnard, *supra* note 177, at 86-88 (arguing that shareholder-elected directors are no more likely to focus on short-term objectives than traditional directors and that "providing shareholders access to the proxy would *encourage* long-term thinking").

416. *See* Barnard, *supra* note 177, at 88-89. It is especially important that shareholder-nominated directors understand that they must act independently of the shareholder or shareholder group responsible for their original nomination. If such directors are closely controlled by the shareholder responsible for their nomination, the shareholder runs the risk of liability as a control person under the securities laws. Black, *supra* note 348, at 548-49.

417. Barnard, *supra* note 177, at 84-86.

make the market for control decidedly imperfect.[418] Given the extent of state and federal regulation of tender offers, and the prevalence of anti-takeover measures adopted by corporations, it is naive to suggest that anything approaching a "perfect" market for control exists.[419] Moreover, the market for control simply cannot redress situations where the corporation would be better off if it replaced some, but not all, of its directors.

IV. HOW TO GIVE SHAREHOLDERS A GREATER VOICE

Congress and the SEC can and should take several steps to facilitate a more meaningful role in corporate governance for the shareholders of American corporations. Because corporate directors are unlikely to voluntarily adopt these suggestions, firm legislative or regulatory action is required. While states might be willing to adopt legislation along the lines suggested herein, guidance on most of these proposals needs to originate in Congress or with the SEC. State legislatures and courts actually bear significant responsibility for the existing imbalance in power between management and shareholders;[420] it seems unlikely that they would now act to redress that imbalance by giving shareholders more power at the expense of directoral discretion. Even if state legislatures did enact the changes needed to improve the role of shareholders in corporate governance, it is virtually certain that the resulting rules would lack uniformity, and highly likely that corporations would reincorporate in any jurisdiction that refused to pass such remedial legislation.[421] Federal regulation thus appears to be the best mechanism to provide shareholders with a meaningful

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418. Barnard, *supra* note 177, at 85. Theorists who postulate that the "market for corporate control" will act as a sufficient deterrent to inefficient management are acting under a number of mistaken assumptions. First, the theory's validity depends on inefficient management being generally vulnerable to takeovers. This assumption is not supported by an examination of current tender offer and takeover regulations. *See supra* notes 261-95 and accompanying text. Obviously, if legal impediments protect inefficient management from hostile takeover attempts, the very existence of "an uninhibited market for corporate control" is suspect.

Moreover, the theory that the market for corporate control adequately assures reasonable management decisions assumes that the reason takeovers are attempted is in fact to improve management. This assumption is not supported by the evidence. *See supra* notes 235-60 and accompanying text.

419. Barnard, *supra* note 177, at 85 (identifying impediments to market for control). Even assuming that takeovers are motivated by a desire to improve management, the regulatory barriers and restrictions that limit the effectiveness of tender offers and proxy fights means that inefficient management is often protected from such activities. Because existing rules tip the scales in favor of existing management, this "market for control" cannot correct or deter management abuses.

420. *See supra* notes 71-73, 84-92 and accompanying text (demonstrating that at state level, most movement has been toward *restricting* rights of shareholders).

421. *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 668 (1974).

role in corporate governance. Furthermore, while the SEC could probably institute most of the proposed changes[422] without intervention by Congress, certain modifications may require the passage of new legislation.[423]

This Article recommends various changes to existing law to allow shareholders a greater role in corporate governance. First, the SEC should give shareholders the power to nominate directors. Second, the SEC should amend current proxy rules to remove or limit many of the existing impediments to and restrictions on shareholder proposals. Third, Congress should impose confidentiality requirements on proxy voting in public corporations.[424] Finally, the SEC should guarantee shareholders meaningful access to the shareholder list for their corporation.

A. *The Power To Nominate Directors*

Giving shareholders a real role in the selection and election of corporate directors is one of the most important changes this Article recommends. To accomplish this change, the SEC must revise the existing federal proxy rules. The current system provides virtually no shareholder involvement in the nominating process,[425] and, because of the manner in which directors are nominated, no meaningful role in voting.[426] While this proposal is presented separately from the

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422. The SEC has signaled its willingness to reconsider the proper role of shareholders and shareholder access to the proxy by promulgating the recent amendments to the proxy rules. These amendments were expressly adopted in order to remove "unnecessary limitations on shareholders' use of their voting rights." Shareholder Communications, *supra* note 104.

423. Congress has, in fact, considered several bills that would have redressed some of the imbalance in power between management and shareholders. *See, e.g.*, The Corporate Takeover Reform Act of 1989, S. 1244, 101st Cong., 1st Sess. § 8 (1989); Investor Equality Act of 1989, S. 1658, 101st Cong., 1st Sess. § 9 (1989); Tender Offer Disclosure and Fairness Act of 1987, S. 1323, 100th Cong., 1st Sess. § 2 (1987); Tender Offer Reform Act of 1987, H.R. 2172, 100th Cong., 1st Sess. § 2(a)(1) (1987); Protection of Shareholder Rights Act of 1980, S. 2567, 96th Cong., 2d Sess. § 8(a) (1980); Corporate Democracy Act of 1980, H.R. 7010, 96th Cong., 2d Sess. § 105(a) (1980). While none of these proposals passed, they do indicate a willingness on the part of at least some members of Congress to consider the issue of greater shareholder participation in corporate governance.

424. This change may require legislative action because the current statutory provisions authorizing the SEC to regulate proxies do not give the SEC any direct authority to impose confidential voting.

425. The proxy rules do allow a shareholder to stage a proxy contest over the slate of directors. 17 C.F.R. § 240.14a-7 (1992). Nevertheless, the expenses of staging such a fight make it effectively impractical in all but the most egregious of situations. *See* Sobering, *supra* note 351, at 160. It is true that the most recent set of amendments allow shareholders to include in their slate the names of nominees put forward by management, so long as the shareholder nominees, if elected, would not constitute a majority of the directors. 17 C.F.R. § 240.14a-4(d). As a practical matter, however, this does not reduce the expense of staging a proxy contest.

426. Shareholders, of course, are entitled to vote on directors. This "right" is rendered meaningless, however, if there is only one slate of candidates for whom shareholders can vote.

following suggestions, shareholders will more effectively influence the composition of corporate boards if the SEC also amends the proxy rules to create a level playing field for all shareholder proposals, including those relating to election to office. The full potential benefits of shareholder participation, therefore, are likely to be realized only when the SEC promulgates comprehensive amendments to the existing regulatory structure that redress the existing imbalance in power between shareholders and management.

With regard to the proper role for shareholders in the directoral nominating process, commentators have advocated a variety of models. Some academics have suggested that institutional investors be freed from responsibility to their beneficiaries to allow them a more active role in corporate governance.[427] Others have listed a wide variety of legal constraints on institutional investors that need to be removed, including limitations imposed by the SEC, bank regulators, the Department of Labor under ERISA, and antitrust law.[428] Still other commentators continue to support the idea of independent directors as the solution to the existing problems in corporate governance.[429] Finally, one commentator's proposal is modeled after the two-tiered boards used in large German corporations.[430] Shareholders themselves have proposed the creation of shareholder advisory committees.[431]

The simplest and most direct solution to allow shareholders access to the directoral nominating process would be to amend SEC Rule 14a-8,[432] the shareholder proposal rule, to eliminate the clause that allows corporations to exclude any proposal relating to elections to office from proxy materials.[433] Deleting this clause would allow

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In fact, this practice is the norm in public corporations. If there are 11 directors to be elected, shareholders are presented with a list of 11 names from which to choose. Thus, even though shareholders have the "right" to vote, it is not a meaningful right at this time. *See* Sobering, *supra* note 351, at 159-60.

427. *E.g.*, Conard, *supra* note 322, at 177 (positing that institutional investors' voting rights should be exercised in sole interest of beneficiaries and not dictated by sponsoring business enterprises). The principal concern here seems to be the notion that institutional investors may be required to choose investment options that maximize short-term value rather than long-term interests under existing rules. To the extent that this is the case, amendments to ERISA would be necessary to insure that plan managers are free to consider long-term interests.

428. *E.g.*, Black, *supra* note 348, at 530.

429. *E.g.*, LORSCH & MACIVER, *supra* note 325, at 184-87 (urging that chairman of board should be independent director); Gilson & Kraakman, *supra* note 325, at 863 (advocating outside directors with increased dependence on shareholders).

430. Buxbaum, *supra* note 326, at 1.

431. *See, e.g.*, Barnard, *supra* note 177, at 53 n.91 (citing CalPERS proposals to shareholders of TRW, Avon Products, and Occidental Petroleum).

432. 17 C.F.R. § 240.14a-8 (1992).

433. *See* Barnard, *supra* note 177, at 39 (noting that current rule denies shareholders mechanism for nominating directors).

shareholders meeting the minimum share ownership and holding period requirements to nominate one director to compete with management's nominees.[434]

Of course, allowing shareholders to nominate competing directors may not result in any direct shareholder representation on corporate boards. Nonetheless, it seems advisable to make this change as one step in the effort to provide shareholders with a real role in corporate decisionmaking. In the event that there are an insufficient number of nominations for shareholder candidates to make a difference in the composition of corporate boards, the SEC could further amend the proxy rules to require proxies to include shareholder nominations for a specified percentage of available director positions.[435] The SEC could even transfer control of the nominating process from incumbent management to shareholders.[436] The SEC need not adopt, or even consider at any length, such suggestions, however, until there is some indication that the simple step of allowing shareholder nominations fails to produce the hoped-for benefits of more direct shareholder representation on corporate boards.

It is also possible, however, that unlimited access to the nominating process could overwhelm the proxy system. Corporations may receive too many nominations to include them all in their proxy materials. There are a number of solutions to this potential problem. For example, the SEC could limit the number of nominations that shareholders can make or restrict shareholder nominations to a certain number of candidates, or a certain percentage of the total number of positions to be filled. Alternatively, the SEC could draft the proxy rules so that the corporation would only have to include those nominations supported by a minimum number of shares in the proxy materials. To make this second alternative workable, the SEC might have to adopt an express exclusion from the proxy solicitation disclosure requirements for communications designed to obtain

434. *See* Barnard, *supra* note 177, at 39 (advocating amendment to Rule 14a-8 to allow "a shareholder or shareholder group owning $1 million or 3% of the market value, whichever is less, of a company's voting stock to nominate up to three directoral candidates"). Professor Barnard's proposal is modeled after The Corporate Takeover Reform Act of 1989, S. 1244, 101st Cong., 1st Sess. (1989), an act proposed by Senators Howard Metzenbaum and William Armstrong. The complete proposal, which is detailed in Professor Barnard's article, also calls for equal access to corporate proxy statements and materials. Barnard, *supra* note 177, at 98-99.

435. *See* LOWENSTEIN, *supra* note 150, at 205-29, 256.

436. *See* Dent, *supra* note 206, at 907 (arguing in favor of complete shift in control of proxy solicitation from management to corporation's largest shareholders). Professor Dent's proposal would call for the 10 to 20 largest shareholders of a public company to form a committee to assume complete control over the nomination process. *Id.*

preliminary support for shareholder nominations.[437] Any of these measures would limit the nominating process to avoid overwhelming the proxy system. The question is whether it is necessary to propose such limitations on shareholder candidates at the outset, or whether the SEC should impose such limitations only in the event that the revised rules prove difficult to implement.

Because the corporate governance model for American corporations has systematically excluded public shareholders from the directoral nominating process, there is no direct proof of how shareholders would respond if given the opportunity to nominate directors. The indications are, however, that at least some shareholders would welcome the opportunity to participate in the nominating process. Despite the current formidable barriers to shareholder involvement in the selection of directors, examples of shareholder involvement in selecting directors exist. Perhaps the most widely publicized example is the success of Exxon's institutional investors in forcing the corporation to appoint an environmentalist to its board of directors.[438] Texaco has also appointed a particular nominee to its board of directors at the request of certain institutional investors.[439] Similarly, Lockheed has directors who were directly empowered through the involvement of institutional investors.[440] Finally, institutional investors have closely scrutinized General Motors' directoral selection process.[441]

Based on such evidence, it seems safe to predict that at least some institutional investors will seek greater involvement in the directoral selection process if the SEC makes this option available to them. Moreover, while not all institutional investors are likely to participate,[442] there are sufficient indications of a significant reaction from

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437. Without such an amendment, any shareholders seeking to organize a shareholder group to support a particular candidate might inadvertently violate the proxy solicitation rules. While the proxy rules, as amended, generally permit communications among shareholders who are not seeking proxy authority, this authorization does not extend to the largest shareholders who are participating in a contested election of directors. 17 C.F.R. § 240.14a-2(b)(1)(vi) (1992).

438. *See* Carolyn K. Brancato, *Who Owns Corporate America—The Momentum of the Big Investor*, DIRECTORS & BOARDS, Winter 1990, at 38, 45; *They Own the Company (Exxon Appoints Environmentalist to Board)*, L.A. DAILY J., May 25, 1989, at 6.

439. Brancato, *supra* note 438, at 45 (discussing appointment to board of pension fund nominee as part of fund's agreement to vote with board in proxy fight against dissident shareholder Carl Icahn).

440. *See* Marcia Parker, *'90 Proxy Victories Leave Key Questions*, PENSIONS & INVESTMENTS, Apr. 16, 1990, at 1, 32 (citing involvement of CalPERS, New York City Employees' Retirement System, and Florida State Board of Administration in appointment of directors at Lockheed).

441. *Id.*

442. *See, e.g.*, Leonard J. Hollie, *Activism Not Role for Firms*, PENSIONS & INVESTMENT AGE, Oct. 2, 1992, at 17 (explaining that mutual fund managers generally do not want to make changes to corporate boards).

the institutional investor community to justify imposing some limitations on shareholder participation in the nominating process.

In order to avoid the risk of overburdening the proxy machinery, it seems advisable to avoid unlimited access to the nominating process. The simplest approach would be to limit the total number of nominations that a corporation must include in the proxy materials. The SEC should allow shareholders, as a group, to nominate one person for every two positions to be filled on the board of directors at a given meeting. If there are more shareholder nominations than positions available, those nominations endorsed by shareholders having the most shares should be selected for inclusion in the proxy materials.[443]

The SEC should impose additional limitations on shareholders' rights to nominate directoral candidates. To avoid making directoral nominations a weapon in contests for corporate control, no one shareholder should be allowed to nominate more than one-fourth of the total number of directors at any one annual meeting. While this limitation does not eliminate the possibility that directoral nominations will become a new arena for takeover battles, it will prevent a single shareholder from staging a complete takeover in one meeting.[444]

In addition, short-term shareholders should not be eligible to nominate directors. Large investors have the ability and, because of the inadequacies of the Wall Street Rule, often the incentives to monitor managerial behavior.[445] Certain investors, even if they are large institutions, do not meet the second of these criteria. Notably, arbitrageurs or program traders are unlikely to spend the time and money necessary to engage in any meaningful oversight of board activity even though they might have the ability to do so. Thus, only shareholders who have held their stock for a minimum of one year should be allowed to use those shares to support the nomination of

443. To prevent one large shareholder from controlling the entire shareholder nomination process, shareholder groups could be formed where every participating shareholder would be allowed one endorsement per share.

444. To prevent groups of shareholders from staging takeover attempts through the proxy process, the SEC could require every shareholder nominating a directoral candidate to disclose whether they have entered into any arrangement with any other shareholder with regard to the election or nomination of other candidates. Failure to properly disclose such agreements, and to respect the limits on the number of permissible directors, could result in the exclusion of the shareholders' candidates from the proxy materials.

445. *See supra* notes 166-67 and accompanying text (noting difficulties and drawbacks for large investors who contemplate selling their shares in favor of alternatives).

shareholder candidates for directors.[446] This requirement is clearly in line with existing requirements for shareholder proposals.[447]

Finally, one last amendment to the proxy rules is needed to effectuate shareholders' power to nominate candidates. The existing proxy rules permit management to exclude any shareholder proposal that attacks management personally, or is counter to any management proposal.[448] Without amendment, management could use these provisions to substantially restrict the ability of shareholders to nominate directors. At the very least, the language of the existing rules would make it impossible for shareholders nominating candidates to include criticism of management's nominees in their description of why other shareholders should elect their candidates. An additional amendment or clarification to the proxy rules is therefore needed to ensure that shareholders nominating directors will be allowed to provide a full and complete analysis of candidates without fear that management will be able to exclude it.[449]

B. *Creating a Level Playing Field for Shareholder Proposals*

Permitting shareholders to nominate directors would go a long way toward providing shareholders with a meaningful role in corporate governance. Even so, additional amendments to make the shareholder proposal process more balanced should also be considered. In the past few years, institutional shareholders have sponsored and supported a large number of shareholder proposals relating to corporate governance issues.[450] In order to give shareholders a meaningful say in the operation of their corporations, the proxy rules should allow shareholders to present such proposals in terms and under conditions that are reasonably fair.

The existing rules regulating shareholder proposals place too many limitations and restrictions on shareholders wishing to make such proposals. Under the current rules, shareholders are limited to one proposal per meeting,[451] regardless of the extent of their interest in

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446. Not only would this suggestion minimize the risk that short-term investors would select directors with no interest in the long term, it would also encourage shareholders to become long-term investors by rewarding long-term investors with the right to participate in the nomination process.

447. 17 C.F.R. § 240.14a-8(a)(1) (1992) (requiring that proponent of shareholder proposal must have owned his or her shares for at least one year).

448. *Id.* § 240.14a-8(c)(9).

449. Management should retain the right to exclude any nomination materials that include false or misleading information. Liability for erroneous information should be imposed on the proponent and candidate rather than on the registrant.

450. *See supra* part I.D. (discussing increased shareholder activism).

451. 17 C.F.R. § 240.14a-8(a)(4) (1992).

the corporation. The supporting statement that proponents are allowed to include may not exceed 500 words, including the proposal itself,[452] despite the fact that there is no limit on the length of management responses.[453] In addition to the preceding limitations, management can omit shareholder proposals if they fall into any of a number of excludable categories.[454] Management can exclude proposals from proxy materials if they are not the "proper subject" for a shareholder vote, if they relate to an issue that is insignificant to the corporation's business, or if they relate to the ordinary business of the corporation.[455] In recent years, the SEC has permitted management to exclude numerous shareholder proposals on such grounds.[456] Generally speaking, management's power to exclude shareholder proposals seems excessive.

The SEC should ease, or even eliminate, each of these limitations and restrictions on shareholder proposals. The rules should not limit large shareholders to one proposal per year, should not limit explanatory statements to 500 words, should not force resolutions to be merely precatory in nature, and should allow shareholders to determine which issues are significant, including those that relate to the ordinary business of the corporation. Each of these suggestions will be addressed in turn.

1. Multiple proposals

The purpose behind the one-proposal-per-meeting rule is clear: requiring the corporation to include an unlimited number of shareholder proposals from all interested shareholders meeting the minimal ownership requirements[457] of the current proxy rules could easily make the proxy solicitation process unwieldy. The cost of printing and mailing a voluminous proxy statement is a factor,[458] and if the proxy form is exceedingly long and involved, the number of shareholders executing and returning proxies would likely decrease.

While these problems are real, and it does not seem wise to give all

452. *Id.* § 240.14a-8(b)(1).
453. *See id.* § 240.14a-8(e).
454. *See id.* § 240.14a-8(c); *see also supra* note 99 and accompanying text (listing excludable categories).
455. 17 C.F.R. § 240.14a-8(c)(1), (5), (7).
456. *See supra* note 129 (citing several types of proposals that management has successfully excluded).
457. 17 C.F.R. § 14a-8(a)(1) (setting forth share ownership requirements). To be eligible to make a shareholder proposal, the proponent must be the beneficial owner of at least one percent or $1000 in market value of voting securities, and must have owned such securities for at least one year. *Id.*
458. *See supra* note 96 and accompanying text.

shareholders unrestricted access to the proxy process, it does not seem fair or necessary to restrict large shareholders to one proposal per meeting. If the rules provided greater access only to shareholders owning at least five percent or more than $5 million in market value of securities, the risk of overburdening the proxy solicitation process seems minimal. Because these are the very shareholders with an economic stake sufficiently large to make selling their shares an unattractive alternative, and who have the economic justification to allocate resources to evaluate corporate performance on more than a casual basis, they ought to be allowed to make multiple proposals if they deem it desirable to do so. If a numerical limit is deemed essential to satisfy concerns about overwhelming the proxy process, the rules could limit even large shareholders to three or four proposals per meeting, exclusive of directoral nominations. Thus, large shareholders would be able to make more than one proposal when more than one issue is truly compelling, but they would be forced to limit themselves to three or four significant issues. This proposal should give shareholders sufficient access to corporate proxy materials, while protecting the corporation from the risk of excessive expense and unwieldy proxy forms.

2. *Expanded supporting statements*

The existing rules limiting the length of the supporting statement that shareholders may include with a shareholder proposal are also problematic. The proxy rules currently allow the proponent of a shareholder proposal to include a supporting statement along with the proposal, so long as the proposal and statement, in the aggregate, do not exceed 500 words.[459] If the proponent exceeds this word limit, the corporation may exclude the proposal from the proxy materials.[460]

Again, the purpose of this rule seems clear. A supporting statement fifty pages in length would be prohibitively expensive to mail out to thousands of shareholders, and excessively long supporting materials would make it a virtual certainty that shareholders would not read the documentation. Even a single proposal with supporting materials of this clearly excessive length could cause major problems in the proxy solicitation process.

Nonetheless, the current 500-word limit seems unreasonably

459. 17 C.F.R. § 14a-8(b)(1).

460. *Id.* § 14a-8(a)(4) (requiring that corporations give proponent notice and 14 days to reduce size of submission).

restrictive, especially given the fact that there is no similar restriction on the length of the management response.[461] It seems fair to level the playing field by imposing equal and reasonable word limits on shareholder supporting statements and management responses. Five hundred words is a very brief statement, especially when the proponent has reason to expect that management will oppose the proposal.[462] Fifteen hundred words, excluding the words in the proposal itself, seems more reasonable, provided that the corporation, as represented by management, would be similarly limited. In the event that management feels that it cannot comply with its fiduciary duties to adequately inform shareholders in a statement limited to 1500 words, management could be allowed the option of a longer statement, as long as the proponent is given a reasonable opportunity to revise and lengthen its supporting statement. This change would put shareholders on even footing with management, and would limit the unfairness inherent in the existing rules.

3. *Expanding what is "proper" for shareholders to consider*

The current proxy rules permit a corporation to omit from its proxy materials any proposal that is "not a proper subject for action by security holders."[463] The law of the corporation's state of incorporation is used to determine whether a particular proposal is appropriate for consideration by shareholders.[464] This exclusion has prevented shareholders from mandating action by the corporation's directors, and has limited them to precatory or advisory resolutions.

In recent years, some states have adopted provisions that would allow shareholders in close corporations to restrict the power of corporate directors to make certain business decisions, reserving such powers to the shareholders instead.[465] Case law has also liberalized the extent to which shareholders in close corporations are entitled to

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461. *See id.* § 240.14a-8.

462. Five hundred words would be particularly inadequate if the shareholder proposal related to election to office. Federal law requires very specific disclosures about candidates for office; the word limit for statements relating to directoral nominees should be 500 words *exclusive* of all disclosures required by law. *See, e.g., id.* § 240.14a-11(c) (providing filing requirements applicable to corporate director elections).

463. *Id.* § 240.14a-8(c)(1).

464. *Id.*

465. *E.g.*, N.C. GEN. STAT. § 55-7-31 (1993); 15 PA. CONS. STAT. ANN. § 2331 (1993); TEX. BUS. CORP. ACT. ANN. art. 12.35 (West Supp. 1994); *see* REVISED MODEL BUSINESS CODE § 7.32(a)(1) (1983) (permitting shareholders to eliminate directors entirely, or to restrict their powers or discretion, by adopting shareholder agreement to that effect, although such agreements cease to have any legal effect if corporation's shares are listed on national exchange).

restrict the decisional powers of directors in shareholder agreements.[466] It is clear, however, that state law does not extend such rights to shareholders in publicly traded corporations.[467] State law, at least as to public corporations, protects management against shareholder intervention.[468] In light of current state law, deleting the requirement that resolutions concern a proper subject for shareholder action would not be sufficient to authorize shareholders to pass binding resolutions.

In fact, an amendment to the federal proxy rules deleting the section authorizing management to exclude shareholder proposals that are not a proper subject for shareholder action under state law could produce the anomalous result of federal law apparently requiring inclusion of shareholder proposals stated in mandatory terms that, under state law, directors would be free to disregard. Consequently, either the proponent would have to clearly explain that the apparently "mandatory" resolution might not be binding on the corporation's directors, or the directors would have a good case to argue that the proposal should be excluded as misleading.[469] Merely deleting the language in the federal proxy rules that permits management to exclude shareholder resolutions that are not "proper" would thus not have the effect of allowing shareholders to pass binding resolutions.

One approach that would give shareholders the power to pass binding resolutions is to amend state law to permit greater control by shareholders even in public corporations. The advantage to this approach is that if state law did permit the adoption of binding shareholder resolutions, no amendment to federal law would be necessary. State law would then regard such proposals as proper subjects for shareholder action. There is some precedent for the adoption of such rules: state statutes[470] and case law[471] have granted shareholders in close corporations such powers. There is no

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466. *See, e.g.*, Galler v. Galler, 203 N.E.2d 577, 586-87 (Ill. 1964) (holding shareholder agreement in close corporation, relating to directorships, salary continuation payments to widow, and dividends, was valid and not against public policy); Darvin v. Belmont Indus., 199 N.W.2d 542, 544-45 (Mich. Ct. App. 1972) (noting special character of close corporation and analyzing plaintiff's claims in that special context); Westland Capitol Corp. v. Lucht Engineering, 308 N.W.2d 709, 712-13 (Minn. 1981) (treating loan agreement as shareholder agreement and declaring enforceable provision restricting corporate purchase of fixed assets).

467. *See supra* note 57 and accompanying text.

468. *See supra* notes 56-59 and accompanying text.

469. 17 C.F.R. § 240.14a-8(c)(2) (1992) permits the corporation to exclude any proposal that would require the corporation to violate any federal law. Rule 14a-9 prohibits false or misleading statements in a proxy statement. *Id.* § 240.14a-9.

470. *See supra* note 465 and accompanying text.

471. *See supra* note 466 and accompanying text.

indication, however, that states are willing to extend this flexibility to shareholders in public corporations. Moreover, management is likely to oppose the adoption of such rules, and as long as one or more states refuse to grant shareholders such powers, public corporations would probably reincorporate in jurisdictions more supportive of management prerogatives.[472]

Another approach would be to adopt a federal rule requiring directors to accept direction from mandatory shareholder resolutions. Such a rule would preempt conflicting state regulation that, as discussed earlier, generally prevents shareholders in public corporations from mandating action by corporate directors. This approach would provide uniformity and avoid any problem with management "shopping" for a state of incorporation with statutes more favorable to management. This approach, however, would require federal action on an issue that has traditionally been left to the states.[473] Congress undoubtedly has the power to adopt such regulations,[474] and unless states make an abrupt about-face and show a willingness to offer shareholders in public corporations the power to pass binding resolutions, the only alternative, if this proposal is to be implemented, is for Congress to act.

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472. *See* Cary, *supra* note 421, at 666, 701 (condemning "race to the bottom" where each state attempts to draft statutes more favorable to management than other state statutes in order "to encourage incorporation within its borders"). *But see* S. Samuel Arsht, *Reply to Professor Cary*, 31 BUS. LAW. 1113, 1115 (1976) (characterizing Professor Cary's view of Delaware case law as selective and disingenuous); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 921, 944 (1982) (arguing that "race to the bottom" thesis is based on premise of shareholder irrationality).

473. A detailed discussion of the pros and cons of federalizing corporate law is far beyond the scope of this Article. Other commentators have addressed the desirability of federalizing certain corporate law issues, and several have concluded that a federal approach would remedy numerous problems with existing state law. *See, e.g.*, Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1484 (1992) (advocating federal regulation, or at least minimum standards, for issues such as corporate takeovers, proxy contests, parent-subsidiary mergers, and managers' fiduciary duties); Cary, *supra* note 421, at 702 (suggesting federal minimum standards on fiduciary duties, absolution of nonvoting shares, and more frequent requirement of shareholder approval for corporate transactions); Karmel, *supra* note 205, at 55 (urging federal protection of voting rights and increased shareholder responsibility); Donald E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125, 1139 (1976) (arguing for federal incorporation of larger corporations).

474. The Commerce Clause certainly seems broad enough to permit federal regulation of the aspects of corporate governance addressed in this Article. *See* Cary, *supra* note 421, at 703; Note, *Federal Chartering of Corporations: Constitutional Challenges*, 61 GEO. L.J. 123, 134 (1972). Section 12(g) of the Securities Exchange Act of 1934, 15 U.S.C. § 78l, has been described as "at least the second cousin, if not the first cousin, to federal incorporation in substance," and no one has seriously challenged its constitutionality. Louis Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27, 29-30 (1969).

4. *Ordinary business matters*

The SEC has permitted management to exclude a wide variety of shareholder proposals on the grounds that they relate to the ordinary business of the corporation.[475] For example, the SEC has permitted exclusion of proposals limiting the number of officers,[476] and proposals requiring directors to report negative votes.[477] Resolutions condemning particular officers, directors, or the entire board, or asking for a vote of "no confidence," have also generally been excluded under SEC rulings.[478] Although reported decisions in this area are rare, courts have upheld these types of exclusions. In *Grimes v. Ohio Edison Co.*,[479] for example, the court permitted a corporation to exclude a shareholder proposal that would have required the approval of corporate capital expenditures in excess of a specified minimum on grounds that it related to the ordinary business of the corporation.[480]

Such proposals are obviously of significance to the shareholders involved, or they would not take the time to formulate the resolutions and the necessary supporting documentation, and risk the displeasure of management. The issue is whether management ought to be able to prevent a vote on these issues that are clearly important to shareholders on the grounds that they relate to the corporation's ordinary business.

One argument in favor of allowing the exclusion of such proposals is that they are insignificant in relation to the corporation's business.[481] If this is the true justification for exclusion, however, there is a separate provision that specifically authorizes exclusion of proposals that relate to operations accounting for less than five percent of the corporation's assets, sales, and earnings, and which are not otherwise significantly related to the registrant's business.[482] Management does not need to exclude matters relating to ordinary business in order to avoid burdening the proxy materials with "insignificant" matters. To the extent that shareholders are sufficient-

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475. *See supra* note 129 and accompanying text.

476. *See* Eppler & Leibowitz, *supra* note 124, at 796 (noting exclusion of Proctor & Gamble proposal).

477. Eppler & Leibowitz, *supra* note 124, at 796 (citing exclusion of Union Electric proposal).

478. Eppler & Leibowitz, *supra* note 124, at 838-40 (citing exclusions of proposals by Healthrest, UAL Corp., Time-Warner, and Exxon).

479. 992 F.2d 455 (2d Cir. 1993).

480. Grimes v. Ohio Edison Co., 992 F.2d 455, 458 (2d Cir. 1993); *see also* Curtin v. AT&T, 124 F. Supp. 197, 197 (S.D.N.Y. 1954) (permitting exclusion of proposal relating to budget).

481. *Grimes*, 992 F.2d at 457.

482. *See* 17 C.F.R. § 240.14a-8(c)(5) (1992).

ly concerned with ordinary business matters to draft a shareholder proposal in conformity with the proxy rules, a corporation should include such a proposal in the proxy materials. Management should not have the power to preclude shareholder proposals on this ground.

C. *Confidentiality of Proxy Voting*

The preceding suggestions offer a possible basis for permitting active shareholder involvement in the directoral nominating process, and for creating a level playing field for shareholder proposals by removing existing limitations and restrictions. This next proposal is also intended to create a fairer environment for shareholders who wish to participate in corporate governance. This suggestion relates to the confidentiality of shareholder voting.

In most American corporations, management has access to proxies as they are returned.[483] Management can readily determine how given shareholders intend to vote and how they actually cast their ballot. The lack of confidentiality in proxy voting is a significant barrier to shareholder proposals and yet another way in which the balance of power has been tipped in favor of management. Management can pressure shareholders to agree with management on proposals,[484] threaten retaliation,[485] and resolicit proxies if they find that they are not doing well during the initial solicitation.[486]

Various shareholders, who are well aware of the lack of confidential voting in American corporations, argue that confidentiality is necessary to guarantee the integrity of the proxy voting process. For example, CalPERs stated, in support of its 1988 confidential voting proposal to Ryder System, that the proposal was "submitted with the goal of protecting what we consider to be one of the most crucial rights of all shareholders: the integrity of the vote."[487] Shareholder rights activist T. Boone Pickens, Jr., describes the existing process as follows: "Think about it: Public corporations are the only place in America where you sign your ballot, send it to the incumbent and ask him how the election turned out. They didn't do that even when I was running for homeroom president in the fifth grade."[488]

On the other hand, opponents of confidential voting say that the

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483. *See supra* note 133 and accompanying text.
484. *See supra* note 134 and accompanying text.
485. *See supra* note 134 and accompanying text.
486. *See supra* note 135 and accompanying text.
487. MCGURN, *supra* note 133, at 53.
488. MCGURN, *supra* note 133, at 54.

political analogy is inapt;[489] they argue that, because the vast majority of American companies use the open ballot, it cannot possibly be wrong.[490] In addition, it is often argued that Congress or even the SEC could have chosen to mandate or recommend confidential voting, and the decision not to do so must represent a considered opinion that no such change is needed.[491]

As a consequence of open ballots, if it looks like a shareholder proposal is garnering a significant measure of support, something that management can generally determine because the process is not confidential, there is nothing to prevent the corporation from pressuring shareholders to vote with management, and even from resoliciting proxies in an attempt to defeat the proposal. Not surprisingly, then, evidence suggests large shareholders are subject to varying degrees of pressure to vote with management on contested issues. Institutional shareholders, in response to surveys promulgated by the Investor Responsibility Research Center, have indicated that management representatives have contacted them to discuss pending proxy votes, and that the level of contact has increased.[492] Other surveys have documented the same phenomenon.[493] There is evidence that at least some institutional investors have succumbed to management pressures to vote for proposals that may not have been in the shareholders' best interests.[494] Threats of retaliation need not be overt; banks, insurance companies, and investment firms have all indicated that they operate under the assumption that management will "not look kindly upon a vote on a significant proxy proposal that . . . [is] contrary to management's wishes."[495]

These pressures, as well as the threat of resolicitation, could be resolved by mandating confidentiality of proxy voting. A number of corporations, although still a minority, have voluntarily adopted

489. For example, Donald D. Geary, president of the American Society of Corporate Secretaries, wrote to members of the House Energy and Commerce Subcommittee on Telecommunications and Finance to oppose a secret ballot provision. He explained that "[c]orporate elections do not involve matters that require the protection of citizens' privacy." MCGURN, *supra* note 133, at 56. Management of Lockheed and General Dynamics have also publicly opposed treating corporate voting like a political election. *Id.*

490. MCGURN, *supra* note 133, at 59-61.

491. MCGURN, *supra* note 133, at 59.

492. MCGURN, *supra* note 133, at 64.

493. MCGURN, *supra* note 133, at 65 (citing 1988 survey of 250 portfolio managers and executives by N.Y. Society of Security Analysts that found that 22% of respondents believed that they had been subjected to "undue pressure" to vote particular way during 1988 proxy season).

494. J. HEARD, CONFLICTS OF INTEREST IN THE PROXY VOTING SYSTEM (1987); MCGURN, *supra* note 133, at 66 (citing 1987 report by IRRC).

495. MCGURN, *supra* note 133, at 67.

confidential proxy voting,[496] and their experience suggests that it is quite workable.[497] Nonetheless, most American companies have resisted the idea.[498]

The question of whether or not confidential voting would make a significant difference in terms of shareholder participation in corporate governance cannot be answered with complete certainty. Confidential voting would at least remove the appearance of impropriety that currently taints the proxy process. Confidential voting would remove the possibility of resolicitations[499] and would eliminate fear that management would retaliate against a shareholder who voted in opposition to a particular management position.

The clearest indication that confidential voting is viewed by investors as significant to corporate governance is the intensity of efforts in recent years to have management accept confidential voting on a voluntary basis. Several shareholder proposals have urged confidential voting,[500] and these proposals have garnered increasing levels of support among shareholders.[501] If shareholders did not view confidential voting as an important issue, one would assume that they would not devote so much time and energy to the issue.

Of course, confidential proxy voting can take several forms. For example, in the American corporations that have adopted confidential voting, there is great disparity in the detail with which the confidenti-

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496. In 1989, the IRRC conducted a survey of 22 American companies that had adopted rules providing for confidentiality of proxy votes. MCGURN, *supra* note 133, at 49. The following companies had adopted confidential proxy voting: Alcoa, American Brands, AT&T, Chase Manhattan, Chemical Banking, Chevron, Citicorp, Datapoint, DuPont, Exxon, General Electric, General Mills, General Motors, IBM, ITT, Loral, Mesa Limited Partnership, 3M, J.P. Morgan, Sara Lee, United Technologies, and Xerox. *Id.*

While the policies adopted by these companies differ in detail, there are a number of common characteristics. All of the companies have agreed that signed proxies, ballots, and voting tabulations will be seen only by tabulators, except in certain limited circumstances. *Id.* An independent tabulator is hired to tally the votes. *Id.* The votes are verified by independent inspectors, and management is given the vote totals, along with a transcription of any comments written on the proxies. *Id.* The proxies are retained for one to three years, and then destroyed. *Id.*

497. *See supra* note 133 and accompanying text.

498. *See supra* note 133 and accompanying text.

499. A resolicitation occurs when management, after reviewing preliminary information from proxies, decides to send out additional materials to encourage a change in voting by some shareholders. For example, in 1981, shareholders sponsored resolutions calling for the adoption of confidential voting at American Home Products, Abbott Laboratories, and Bristol-Myers. MCGURN, *supra* note 133, at 20. All three companies admitted resoliciting proxies based on information that significant shareholders had opposed management or abstained from voting. *Id.* at 22.

500. MCGURN, *supra* note 133, at 5 (reporting that in 1988, there were 16 shareholder proposals asking American corporations to adopt confidential voting). In 1989, more than 50 such proposals were planned. *Id.* at 5-7.

501. *See* MCGURN, *supra* note 133, at 22 (explaining that average support for shareholder proposals calling for confidential voting increased from 6.1% in 1980 to 18.8% in 1988).

ality requirement is imposed, and in the procedures by which such confidentiality is guaranteed.[502] Ideally, any system of confidential voting should provide that, except as necessary to comply with applicable law, only the chosen tabulators, who should not be members of or related to management, should view the signed proxies, ballots, and votes. The independent tabulators should count all votes, which should be verified by independent inspectors. Management should have access only to the vote totals with respect to each proposal, and not to the identities of those casting the votes.[503] The tabulators or inspectors should store the proxies for a set period of time, and then should destroy them. These steps should provide reasonable protection for shareholders who do not want it known that they disagree with management on particular items.

D. *Access to the Shareholder List*

Yet another way in which the SEC should amend the federal proxy rules is to allow shareholders meaningful access to the corporation's shareholder list. Under federal law, shareholder proposals are included in the corporation's own proxy materials; there is no requirement that management provide the proponent with a list of shareholders.[504] If a dissident shareholder wishes to circulate separate proxy materials, federal law ensures that the shareholder will be able to do so, but gives the corporation the option of providing the shareholder with a mailing list *or* handling the mailing itself, at the shareholder's expense.[505] Because management has a vested interest in preventing a dissident from having free access to other shareholders and in avoiding the dissemination of its mailing list, it is not surprising that management overwhelmingly favors the option of mailing the materials for the dissident shareholder.[506]

State law also fails to provide meaningful access to shareholder lists. While many state corporate statutes require corporations to prepare a shareholder list in contemplation of shareholder meetings, and to give shareholders access to the list, the access is generally guaranteed only for a very brief period of time. Delaware, for example, requires

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502. *See* MCGURN, *supra* note 133, at 37-52 (discussing various confidentiality policies that corporations have adopted).

503. Comments on the proxies can be transcribed and reported to the corporate secretary without revealing the identity of the shareholder granting the proxy.

504. 17 C.F.R. § 240.14a-8 (1992).

505. *Id.* § 240.14a-7.

506. Black, *supra* note 348, at 542 (contending that companies invariably mail materials themselves to avoid disclosing shareholder names).

the preparation of a shareholder list at least ten days before any shareholder meeting, and provides that such list must be available to shareholders for at least ten days before the meeting.[507] This ten day period, which may be perfectly adequate to permit communication in a closely held corporation with a small group of shareholders, is grossly inadequate to permit meaningful communication between the hundreds or even thousands of shareholders in public corporations. Other state statutes are similarly inadequate when it comes to requiring that management provide shareholders with access to a shareholder list.[508]

Because it is necessary to identify shareholders before one can communicate with them, this lack of access to shareholder lists is a significant impediment to communication. Although institutional shareholders are likely to know the identities of other large shareholders, if shareholder proposals are to gain widespread acceptance, communication cannot and should not be limited to a few large shareholders.[509]

CONCLUSION

It is difficult to contend seriously that shareholders have a meaningful role in corporate governance under existing regulations. The deck is clearly stacked in favor of management, and the real issue is whether this imbalance has created any problems that could be resolved by providing shareholders with greater opportunities to participate in corporate decisionmaking.

This Article has examined a few of the more clearly documented areas in which managerial abuses are widespread. Decisions to initiate takeovers, decisions to oppose them, and decisions concerning executive compensation have all been subject to substantial abuses, to the detriment of shareholder interests. None of the existing

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507. DEL. CODE ANN. tit. 8, § 219(a) (1993).

508. *See, e.g.*, N.Y. BUS. CORP. LAW § 607 (McKinney 1986) (mandating that list be available during meeting); TEX. BUS. CORP. ACT ANN. art. 2.27 (West Supp. 1993) (requiring that corporation make list available for 10 days).

509. Under prior law, it is likely that any such communication would have been classified as a solicitation, and would have had to comply with the federal proxy rules as to form and content. In the October 1992 amendments to the proxy rules, however, the SEC acted to exempt from regulation communications by persons who do not seek proxy authority, and are not otherwise ineligible. Shareholder Communications, *supra* note 104, at 20. These rules are to be codified at 17 C.F.R. § 240.14a-2(b). From the standpoint of corporate governance, there are two important limitations on this exemption: it does not apply to any person (1) who is interested in the subject matter of the vote, or (2) who owns more than five percent of the outstanding securities of any class and has an interest in or intent to contest a solicitation for the election of directors.

mechanisms for curbing such abuses have proven effective. This Article does not, however, seek to redress these particular concerns by proposing greater regulation in the area of takeovers or executive compensation. Rather, it proposes amendments to existing regulations to give *shareholders* the ability to restrict management discretion in areas where abuses occur. Specifically, these amendments would allow shareholders to propose binding resolutions, and give them the ability to hold management accountable by nominating and electing new directors if management fails to protect shareholder interests. These suggestions would not only redress the particular problems identified in this Article, but also the more general problems stemming from shareholder disenfranchisement and lack of accountability by management.

No longer would shareholders be encouraged by the Wall Street Rule to sell out rather than work with management. Instead, these recommendations would create a real incentive to longer term investment by offering shareholders who retained their shares for at least one year the opportunity to participate in the directoral nominating process. And finally, such changes at least attempt to use shareholder participation in corporate governance as a solution to poor decisionmaking. Even if shareholder participation does not work as planned, at least then we will know that a solution lies elsewhere.