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Shareholder vs. Director Control over Social Policy Matters: Conflicting Trends in Corporate Governance

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ARTICLES

**SHAREHOLDER VS. DIRECTOR CONTROL
OVER SOCIAL POLICY MATTERS:
CONFLICTING TRENDS IN CORPORATE
GOVERNANCE**

H. RODGIN COHEN*
GLEN T. SCHLEYER**

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I. INTRODUCTION

In this Article, we discuss a trend toward increased direct shareholder influence over the business practices of U.S. public companies—utilizing their social policy practices as a leading example. The 2011 proxy season saw a continued increase in the presentation of shareholder proposals on social issues, including environmental, political, non-discrimination, and health-related issues, as well as executive compensation practices. The support for these shareholder proposals reached an all-time high, with a small (but record) number actually receiving majority approval of votes cast. A number of policy changes by the staff of the Securities and Exchange Commission (“SEC”) in recent years have made it more difficult for companies to exclude these proposals under Rule 14a-8 under the Securities Exchange Act of 1934.¹ Moreover, a combination of the widespread adoption of majority voting in director elections and the influence of proxy advisory firms’ recommendations on director elections means that directors face significant adverse consequences if the company does not implement social policy proposals that shareholders have approved.

1. See, e.g., SEC Staff Legal Bulletin No. 14E, 2009 WL 4363205 (Oct. 27, 2009). See discussion *infra* Section III.D.

Advocates of Rule 14a-8 social policy proposals assert that they advance “shareholder democracy” and are a powerful and valid tool for social change and moral improvement of corporate behavior. Their use, however, seems conceptually inconsistent with the corporate governance shift over past decades toward the primacy of oversight by a strong, independent board of directors. This Article discusses the issue of direct shareholder influence in the context of other governance developments in recent decades, under various theories of corporate law and as a matter of shareholder democracy more broadly. Our conclusion in this Article is that social policy considerations fall squarely within the management of the business and affairs of the corporation, and that—although shareholders may perform a valuable service by creating awareness of social issues—direct shareholder influence over these and similar matters can undermine director independence and judgment and work to the detriment of corporations, shareholders, and society more broadly.

This Article is organized as follows:

Part II describes how legal, regulatory, judicial, and other governance developments of recent decades—from the 1970s through today—collectively resulted in a corporate governance model for public companies that consisted of the following complementary elements:

- empowering the board of directors as a control on management and as a protector of shareholder interests;
- facilitating shareholders’ ability to protect and structure their state law voting rights on director elections;
- expanding public company proxy disclosure as to governance matters so that shareholders may have the information necessary to make appropriate voting and investment decisions; and
- providing means for shareholders to communicate with the independent directors, so directors can make decisions with an awareness of shareholder concerns.

Part II examines these developments against the backdrop of three principal theories of corporate law through which one may analyze the appropriate balance of power among shareholders, directors, management, and other stakeholders: the contractarian (or law and economics) view; the shareholder-centric ownership view (in which shareholders are seen as the owners of the firm and the directors as agents of the shareholders); and the social responsibility view (often referred to as a communitarian

or stakeholder model). Part II discusses how the corporate governance developments described above support a director-centric application of the contractarian view of the corporation. Part II will also discuss how this approach is consistent with the view of the corporation that is prevalent under state law (Delaware law in particular), which views the board of directors as a *sui generis* body with original and undelegated powers to oversee the business and affairs of the corporation, with the interests of shareholders (as they relate to the corporation's business practices) protected by their right to elect directors and the fiduciary obligations owed to them by directors.

Part III describes how developments in federal regulation of the proxy process have given shareholders more direct influence over the business practices of U.S. corporations. Part III analyzes the history of the SEC's treatment of social policy proposals, including tracing the path from the SEC guidance in 1945 expressly permitting *exclusion* of proposals of a "general political, social or economic nature" to the current, nearly opposite approach whereby proposals may *not be excluded* if they raise "significant policy considerations."

Part IV discusses how, despite the precatory nature of Rule 14a-8 social policy proposals, the outcome of these votes potentially present directors with significant conflicts in the exercise of their fiduciary duties. Due to the widespread adoption of majority voting in director elections, together with the policies and influence of proxy advisory firms, directors of a company that does not implement a shareholder-approved proposal may face automatic "withhold vote" recommendations, which can impair their independent exercise of judgment. The elimination of broker discretionary voting in director elections and the advent of proxy access have given even greater force to these withhold vote recommendations.

Part IV goes on to discuss the inconsistency between direct shareholder influence over business practices and the dominant board-focused governance model. Directors' own views of what is in the best long-term interest of the corporation and shareholders may be in conflict with the views expressed in a shareholder-approved proposal, particularly in the case of social policy proposals, and directors who favor the former over the latter (as state law and legal theory suggest they must) do so at the risk of being voted out of office through the operation of the modern proxy advisory system. This level of direct shareholder influence over corporate policy is not compatible with prevalent corporate theory and with the more dominant director-based focus of corporate law developments over the past several decades. This

inconsistency can be resolved if the SEC interprets the “ordinary business” exclusion under Rule 14a-8(i)(7) to permit exclusion of shareholder proposals that relate to the board’s oversight of the business and affairs of the corporation, including oversight of social policy issues.

Part V examines the oft-mentioned concept of shareholder democracy to determine whether general democratic principles provide a basis for shareholder direct governance in the context of social policy proposals. The question of whether a democratic government should be governed as a participatory system or a representative system is a longstanding one. Part V will discuss the history of this question, from Ancient Greece, through founding of the more modern representative structure (including the strong concerns that James Madison, Baron de Montesquieu, and others had regarding participatory or direct democracy among a broad and diverse populace).

Part V goes on to examine how the difficulties presented by direct democracy in the political arena are potentially even more problematic, and less consistent with democratic principles, in the corporate arena. Thus, an appeal to “shareholder democracy,” while facially compelling, does not alleviate the concerns that direct shareholder influence as to social policy matters may undermine the fundamental corporate concept of director primacy, potentially to the detriment of the corporation’s stakeholders.

II. THE RISE OF THE BOARD OF DIRECTORS IN CORPORATE GOVERNANCE

The last decade has seen a wave of enhanced corporate governance requirements for U.S. public companies, implemented primarily through stock exchange listing standards and SEC disclosure rules, and buttressed by the advocacy of activist shareholders and the influence of proxy advisory firms. These developments, along with the Sarbanes-Oxley Act of 2002 (“SOX”),² were largely a reaction to a number of prominent corporate scandals and failures. The keystone to many of these governance developments has been an increased emphasis on a strong, qualified, and independent board of directors, including key independent board committees.

This, however, is just the latest advancement in a decades-long movement toward the centrality of the board of directors in

2. Sarbanes-Oxley Act of 2002 (SOX), Pub. L. 107-204, 116 Stat. 745 (2002).

corporate governance. The most recent surge in attention on the role of the board prior to the SOX era occurred in the 1970s.

A. *The 1970s—Attention Shifts to the Board*

Just as in the 2000s, a number of prominent financial scandals, most notably the bankruptcy of Penn Central in 1970, precipitated the focus on board effectiveness in the 1970s. Penn Central's collapse was the largest bankruptcy in U.S. history at that time, and the size, suddenness, and unforeseen nature of the collapse spurred significant post-mortem analysis by the legal, regulatory, and shareholder communities, including a voluminous 1972 report to Congress by the staff of the SEC.³ Among the many areas addressed by the SEC staff's report were the level of involvement and performance of outside directors. The SEC's report is notably critical of both Penn Central management and the board for not ensuring appropriate board oversight of company affairs, including providing the board with sufficient information.

The questions raised following the Penn Central bankruptcy about the appropriate role of the board in corporate affairs came around the time of other high-profile corporate failures, and a number of seminal Delaware law opinions that focused on, and arguably expanded, the role of outside directors.⁴ William Casey, then Chairman of the SEC, took the opportunity, in the cover letter to the Penn Central Report, to indicate that the SEC, "taking a look at the future, has paid increasing attention to the role, the qualifications, the responsibilities, and the independence of

3. STAFF REPORT OF THE SEC TO THE SPECIAL SUBCOMMITTEE ON INVESTIGATIONS, THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY (1972) [hereinafter PENN CENTRAL REPORT].

4. See, e.g., *Gould v. Am. Hawaiian S.S. Co.*, 351 F. Supp. 853, 859 (D. Del. 1972) ("When possible, the [statute] should be interpreted to afford incentives to directors to undertake active and rigorous scrutiny of corporate activities . . ."); see also *Escott v. Barchris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968) (holding that outside directors inappropriately relied on management and outside auditors, without further investigation, as to the accuracy of a prospectus). These cases can be seen as the start of a movement away from the more traditional view under Delaware law that allowed for more remote involvement by directors, at least with respect to compliance issues, such as that reflected in *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) ("[A]bsent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."). This shift in the view of director responsibilities led eventually to the effective reversal of the *Allis-Chalmers* decision in the landmark case, *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). See discussion *infra* Section II.B.2.

corporate directors.”⁵ Indeed, a few months before the release of the Penn Central report, the SEC issued an accounting release that “endorsed” (though it did not require) the establishment by all public companies of audit committees composed entirely of outside directors.⁶

The SEC also used the 1972 failure of Stirling Homex, a housing development company, as an opportunity to focus attention on the role of outside directors. A 1975 SEC public report focused specifically on the limited role of the two non-management directors on the seven-person board, and their apparent lack of a “significant role in the direction of [the] company’s affairs.” The report also noted the failure of the board to establish committees to assist in its responsibilities, the absence of an internal system by which the board received information, and the general failure of the outside directors to bring their “considerable business experience and sophistication” to bear for the benefit of shareholders.⁷

Independent audit committees, in particular, became increasingly common through the 1970s,⁸ following the recommendations for their establishment by the SEC, the American Institute of CPAs (“AICPA”), and the New York Stock Exchange (“NYSE”). In 1974, the SEC followed its earlier endorsement of the use of independent audit committees by a new requirement for proxy disclosure as to the existence and composition of an audit committee.⁹ For its part, the NYSE issued a white paper in

5. PENN CENTRAL REPORT, *supra* note 3.

6. Standing Audit Comms. Composed of Outside Dirs., Securities Act Release No. 5237, Exchange Act Release No. 9548, Investment Company Release Act No. 7091, 1972 WL 125505 (Mar. 23, 1972). This release notes earlier authorities that recommended independent audit committees, including the 1940 SEC accounting release in the wake of the McKesson-Robbins fraud (advocating that “a committee of nonofficer members of the board of directors” be responsible for appointment of auditors) and a 1967 AICPA (American Institute of CPAs) recommendation for independent standing audit committees.

7. Report of Investigation in the Matter of Stirling Homex Corp. Relating to Activities of the Bd. of Dirs. of Stirling Homex Corp., Exchange Act Release No. 11516, 7 SEC Docket 298, 300 (July 2, 1975) [hereinafter Stirling Homex Report].

8. See Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799, 1816 (1976) (citing surveys indicating that fewer than 50% of companies studied had an audit committee in 1973, while more than 89% had an audit committee in 1975).

9. Notice of Amendments to Require Increased Disclosure of Relationships Between Registrants & Their Indep. Pub. Accountants, Securities Act Release No. 5550, Exchange Act Release No. 11147, Accounting Series Release No. 165, 5 SEC Docket 767 (Dec. 20, 1974).

1973 strongly recommending that listed companies have audit committees, indicating that, for listed companies, having an audit committee "no longer represents a corporate luxury but has become a necessity."¹⁰ This best practice became a requirement for NYSE listed companies in 1977, with the adoption of a listing standard requiring independent audit committees.¹¹

During the 1970s, the importance of oversight by an active and independent board of directors became a significant focus of the legal and corporate governance communities. For example, in the early-to-mid-1970s, the ABA Committee on Corporate Laws examined the role of outside directors of public corporations through its Subcommittee on Functions and Responsibilities of Directors, and the recommendations arising from the Subcommittee's work stressed the importance of having an independent board serving in a monitoring capacity.¹² In 1977, the Business Roundtable, a group of CEOs of major corporations, held a symposium on the role of public company directors, which culminated in a paper summarizing the group's views and recommendations.¹³ This paper stressed that, apart from matters specifically requiring shareholder approval under state law, "the board is the ultimate corporate authority."¹⁴ The recommendations of the Business Roundtable supported the trends that were becoming apparent among large public companies, and that would form best practices for years to come. These included majority independent boards and the use of independent audit, compensation, and nominating committees.

The Business Roundtable paper also focused on the idea that the directors protect not just the short-term economic interests of the current shareholders, but serve as the "stewards also of the owners' legal and ethical obligations to other groups affected

10. N.Y. STOCK EXCH., RECOMMENDATIONS AND COMMENTS ON FINANCIAL REPORTING TO SHAREHOLDERS AND RELATED MATTERS 6 (1973).

11. N. Y. Stock Exch., Inc., Exchange Act Release No. 13346, 11 SEC Docket 1945 (Mar. 9, 1977). The Nasdaq Stock Market adopted a similar rule in 1987. See NASD Notices to Members No. 87-46, 1987 NASD LEXIS 137 (July 21, 1987).

12. See, e.g., Leech & Mundheim, *supra* note 8. This paper, prepared in connection with the work of the ABA Subcommittee, comments that the "benefits that have been suggested throughout this paper, of a board dominated by outside directors, can be gained only by guaranteeing that the outsider is truly independent." *Id.* at 1830.

13. See Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 Bus. Law. 2083 (1978).

14. *Id.* at 2097.

by corporate activity.”¹⁵ In order to truly protect the long-term interests of shareholders, the board must consider “the political and social viability of the enterprise over time,” including the impact of the corporation on society more broadly and “the interests and views of groups other than those immediately identified with the corporation.”¹⁶ Balancing these broader societal interests with the more immediate economic and competitive incentives faced by the company is a difficult task, and one that the board of directors, because of its independence and its role as the ultimate corporate authority, is uniquely qualified to undertake.¹⁷

B. *Post-1970s and Pre-SOX*

1. Development of Best Practices

The attention paid during the 1970s to the primacy of the independent directors spurred the development of relatively widespread best practices in the corporate community as to governance structures and board composition. Although prior to 2003, there was no requirement under stock exchange listing standards or otherwise for a U.S. public company to have an independent board of directors, or to have independent compensation or nominating committees,¹⁸ it was already widely considered a best practice for public companies to have a majority of directors who were independent.¹⁹ In addition, business and

15. *Id.* at 2096.

16. *Id.* at 2099–100.

17. The Business Roundtable paper also focused on concerns with social policy-related shareholder proposals, including the use of the corporation as an “arena for debate about issues which should be decided through the political and legislative process” and the fact that “many of the social causes pursued by activist groups represent minority views rather than a prevailing consensus.” *Id.* at 2100–01. As discussed in Part IV, these are concerns that the SEC was grappling with at that time in the Rule 14a-8 context, and that are still an issue today.

18. As discussed above, the NYSE and Nasdaq adopted requirements relating to independent audit committees in 1977 and 1987, respectively. *See supra* note 11.

19. As used in the governance literature, and in this article, the term “independence” generally means that the director is free from financial ties with the company or other relationships with management that would be seen to impair an exercise of independent judgment, though specific definitions of the term vary in different contexts. For examples of best practices recommendations relating to independence during this period, see NAT’L ASS’N OF CORPORATE DIRS., REPORT OF THE NACD BLUE RIBBON COMMISSION ON BOARD EVALUATION: IMPROVING DIRECTOR EFFECTIVENESS I (2001) [hereinafter 2001 NACD Report] (board should have a “substantial majority of independent directors with a wide range of talents, expertise, and occupational and personal

shareholder groups generally considered it a best practice for certain board functions, including nomination of directors and compensation of executives, in addition to oversight of financial audits, to be entrusted to committees of independent directors.²⁰ And, although statistics and surveys show that development was somewhat sporadic, there were distinctive changes in corporate practices in such areas as board composition,²¹ active board oversight²² and the use of independent board committees.²³

background”); BLUE RIBBON COMM. ON IMPROVING THE EFFECTIVENESS OF AUDIT COMMS., REPORT & RECOMMENDATIONS 6 (1999) (urging directors to “understand and adopt the attitude of the modern board which recognizes that the board must perform active and independent oversight”); CAL. PUB. EMPS. RET. SYS. [CALPERS], CORPORATE GOVERNANCE CORE PRINCIPLES & GUIDELINES 4 (1998) (concluding that a substantial majority of the board should be independent directors); BUSINESS ROUNDTABLE, STATEMENT ON CORPORATE GOVERNANCE 10 (1997) (concluding that a substantial majority of the board should be outside directors, and a majority should be independent).

20. See, e.g., 2001 NACD BOARD REPORT, *supra* note 19 (indicating that boards should designate an independent committee, such as the nominating or governance committee to monitor board composition and operations); NAT’L ASS’N OF CORPORATE DIRS., REPORT OF NACD BLUE RIBBON COMMISSION ON EXECUTIVE COMPENSATION (1993) (concluding that executive compensation should be determined by a committee of independent directors). A 1992 survey released by the Business Roundtable and CalPERS found that the vast majority of outside directors agreed that the compensation committee should be fully independent. *Id.* at 1.

21. According to surveys, corporate insiders occupied 63% of board seats in 1972, 25% in 1992 and 18% in 1996. See Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1286 n.14 (1998) (citing Korn/Ferry Int’l, Board Meeting in Session: 20th Annual Board of Directors Study 7, 13, tbl.1 (1993) and Korn/Ferry Int’l, Board Meeting in Session: 24th Annual Board of Directors Study 10, tbl. A (1997)).

22. See *id.*, at 1286 n.13 (citing Korn/Ferry Int’l, Board Meeting in Session: 24th Annual Board of Directors Study 19, tbl. L (1997)) (in 1996, outside directors report an average of 157 hours spent on board-related matters). *Cf. id.* (citing Korn/Ferry Int’l, Board Meeting in Session: 20th Annual Board of Directors Study 19, tbl. 8B (1993)) (stating that from 1988 to 1992, survey respondents reported a decrease in the time directors spent on board matters from an average of one-hundred and eight hours in 1988 to ninety-five hours in 1992). For a further discussion of these and similar governance statistics during this era, see Millstein & MacAvoy, *supra* note 21, at 1283.

23. See KRISTA J. BERK & STEPHEN R. TOBEY, INVESTOR RESPONSIBILITY RESEARCH CENTER, BOARD PRACTICES 1996: THE STRUCTURE AND COMPENSATION OF BOARD OF DIRECTORS AT S&P 500 COMPANIES 9–12 (1996). By 2001, surveys showed that over 91% of public companies surveyed had compensation committees, of which 61% were entirely independent. See 2001 NACD BOARD REPORT, *supra* note 19, at 12.

2. State Law Judicial Decisions

These governance developments were supported by closer judicial scrutiny of the responsibilities of the independent directors as a state corporate law matter. Corporate scandals and takeover battles continued to spur significant shareholder litigation and gave state courts an opportunity to examine the sufficiency of independent director oversight in a variety of situations. In 1996, the Delaware Court of Chancery used a settlement approval proceeding, *In re Caremark International Inc. Derivative Litigation*,²⁴ as an opportunity to address the duty of the board of directors to adopt and maintain a corporate compliance program, even absent any evidence of wrongdoing by management. The *Caremark* decision virtually overruled the 1963 *Graham v. Allis-Chalmers Manufacturing Co.* finding—that directors do not have a general duty to monitor corporate compliance absent evidence of wrongdoing²⁵—by interpreting it very narrowly, and implied that subsequent legal developments compelled more active oversight by the board. Those developments included more onerous federal penalties for corporations that do not have effective compliance policies,²⁶ and various Delaware court decisions in the takeover context that made clear “the seriousness with which the corporation law views the role of the corporate board.”²⁷

The view of the Court of Chancery in *Caremark* that the board has an affirmative duty to monitor corporate compliance was later confirmed by the Delaware Supreme Court in *Stone v. Ritter*.²⁸

24. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

25. See discussion *supra* note 4.

26. In 1991, the U.S. Sentencing Commission first adopted Organizational Sentencing Guidelines, which provided incentives from a sentencing standpoint for companies to have compliance programs in place.

27. *Caremark*, 698 A.2d at 970. The *Caremark* decision cites *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) and *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1993), for this proposition. These cases, together with *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), were viewed as expanding the obligations, and the potential liability, of directors in the takeover context.

28. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006). Although the *Caremark* case and its progeny made clear that the directors have a fiduciary duty to shareholders to establish and maintain a corporate compliance system, they also reaffirmed that directors will not be in breach of this fiduciary duty—even if they acted unreasonably—so long as they acted in good faith. See *Caremark*, 698 A.2d at 971 (“lack of good faith . . . is a necessary condition to liability”); see also *Stone*, 911 A.2d at 370.

3. Legislative and Regulatory Developments

During this period, legislators and regulators further affirmed the primacy of the judgment of independent directors in a number of ways. For example, Section 162(m) under the Internal Revenue Code, which was enacted as part of the 1993 tax reforms, limits the deductibility for federal tax purposes of executive compensation in excess of \$1 million, but provides an exemption for compensation granted based on performance goals approved by a committee of outside directors. The legislative history (and, subsequently, the implementing Treasury regulations) stated that an outside director would not include someone who received compensation for personal services from the company, or who is a former officer of the company, among other things.²⁹ In 1996, the SEC amended its insider trading rules under Section 16 of the Exchange Act to limit an existing director approval exemption from short-swing profit liability for transactions between an insider and the company³⁰ to exclude any director who has any business or other relationship with the company that would be disclosable under the proxy rules.

In this way, state judicial decisions, federal legislative and regulatory changes, and the developing best practices worked together to incentivize companies to develop stronger, more independent and more active boards of directors.

4. Consideration by the Board of Nonshareholder Constituencies

Another development during this era that effectively expanded the autonomy and importance of the board of directors was a clarification of the board's ability to consider interests other than those of shareholders. In many states, this development manifested itself through the adoption of express constituency provisions. From 1983 through 1999, more than half of all states adopted provisions in their corporate laws that permit directors to consider the interests of parties other than shareholders, including employees, creditors, customers, suppliers, and the communities in which the corporation operates.³¹ These statutes were generally adopted in reaction to the active

29. See H.R. REP. NO. 103-213, at 587 (1993) (Conf. Rep.); 26 C.F.R. §1.162-27(e).

30. See Ownership Reports and Trading by Officers, Directors, and Principal Security Holders, Securities Exchange Act Release No. 37260, Investment Company Act Release No. 21997, 62 SEC Docket 138 (May 31, 1996).

31. See Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears*, 1999 ANN. SURV. AM. L. 85, 89, 125-28.

hostile takeover environment of the 1980s and the resulting concern as to whether directors could take a “bigger picture” view of the interests of the “corporate enterprise” beyond a mere immediate financial calculation of the benefit to current shareholders.³²

The Delaware General Corporate Law (“DGCL”) does not have an explicit constituency provision, and it is clear, under Delaware law, that the fiduciary obligations of directors run to shareholders but not to other stakeholders directly.³³ Any historic view, however, that directors must narrowly pursue shareholder wealth maximization strategies³⁴ has long been replaced in Delaware by the judicial recognition of board flexibility in determining the appropriate course of corporate action, including, as appropriate, social policy considerations.

Delaware courts have made clear that, except in the exceptional circumstances arising when the corporation is essentially for sale (in which case the doctrine in *Revlon v. MacAndrews & Forbes Holdings, Inc.*³⁵ provides that the board must act reasonably to maximize immediate shareholder value), the board is able to take the interests of other constituencies into account. For example, in *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court indicated that directors, in assessing a bid, should focus on the “effect on the corporate enterprise,” which may include factors such as “the impact on ‘constituencies’ other than shareholders (*i.e.*, creditors, customers, employees, and perhaps even the community generally).”³⁶ Notably, the *Unocal*

32. See Gary von Stange, Note, *Corporate Social Responsibility Through Constituency Statutes: Legend or Lie?*, 11 HOFSTRA LAB. L.J. 461, 467 (1994).

33. See, e.g., N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007) (holding that directors of a solvent corporation do not owe a fiduciary duty to creditors).

34. The view that directors must act solely to maximize shareholder wealth was expressed most famously in *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919), where the Michigan Supreme Court stated (in dicta) that

[a] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of the directors is to be exercised in the choice of means to attain that end, and does not extend to . . . other purposes.

Id. at 684. This principle has been espoused by a number of legal and economic scholars over the years. See, e.g., Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32.

35. 506 A.2d 173 (Del. 1986).

36. *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 955 (Del. 1985). The court also suggested that not all shareholder interests need be of equal weight—in particular, “a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may

court viewed the proof of the board's good faith and reasonableness as being "materially enhanced" by the fact that the board's decision was approved by a majority of independent directors.³⁷

Although there is a danger in reading too much into *Unocal*, which was concerned with the board's response to a hostile takeover bid, the language suggests that the board's authority to consider societal benefits may be at least somewhat limited. That authority exists if, but probably only if, the "corporate enterprise" is benefitted in some way. There can be broad arguments that a corporation is always benefitted if society as a whole is benefitted, but it remains to be seen whether the Delaware courts would accept such a holistic proposition. The question would be placed in particularly stark relief if the socially beneficial corporate action reduced the corporation's revenues or placed it at a competitive disadvantage, without an identifiable long-term or short-term financial benefit to the company.

Any such limitation on board authority, however, cannot be read too broadly. For example, it is difficult to imagine that directors would be acting outside their authority if they approved a large charitable budget.³⁸ There are seemingly clear reputational benefits that a board is entitled to consider.³⁹

The discretion afforded to directors to consider the societal impact of a corporation's actions is consistent with, and is in fact an example of, the centrality of the role of directors in public corporations.⁴⁰ This flexibility, together with the board's inde-

have fueled the coercive aspect of the offer at the expense of the long term investor." *Id.* at 955-56.

37. *Id.* at 955.

38. See *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 33 (Del. Ch. 2010) (holding that a rights plan was not a proportional response to a threat to "corporate culture," while noting that "[w]hen director decisions are reviewed under the business judgment rule, this Court will not question rational judgments about how promoting non-stockholder interests—be it through making a charitable contribution, paying employees higher salaries and benefits, or more general norms like promoting a particular corporate culture—ultimately promote stockholder value").

39. A significant number of large Delaware public corporations, such as Verizon, Raytheon, Goldman Sachs, McDonald's, ConAgra, and Eastman Chemical, have, in fact, included language in their certificates of incorporation expressly confirming that the board may consider non-shareholder constituencies in making decisions.

40. It is notable that Friedman, *supra* note 34, does not mention directors even once. The article considers only the actions of "corporate executives" and whether they are acting in a responsible manner toward their "employers"—the shareholders. That is, the article is based on a paradigm of shareholder primacy that was replaced in the following decades by the shift toward director primacy. See discussion *infra* Section II.D.

pendence and its ability to consider the overall impact of corporate actions, means that it is in the best position to consider social, moral, and ethical principles in charting the company's course.

C. *The Further Ascent of the Board in the 2000s*

At the turn of the millennium, a consensus had developed within the legal, business, shareholder, and regulatory communities as to the centrality of the board of directors in the oversight of corporate affairs. There was a general sense that a strong, active, and independent board of directors was a bulwark against corporate meltdowns and frauds, and enhanced the ability of corporations to produce value for their shareholders. For example, a 1999 survey noted that companies with fraudulent financial statements were more likely to have boards controlled by insiders.⁴¹ There was, however, relatively little direct regulation at the federal, state, or self-regulatory level as to the composition of the board, use of board committees, manner of board communication, or public disclosure of any of the foregoing.⁴² This would soon change.

The 2001 collapse of Enron—at the time one of the country's largest corporations—and other prominent scandals shortly thereafter, once again drew attention to the role of the board of directors. The Congressional investigation of the Enron collapse, in particular, focused on what Enron's board knew (or should have known) and what they did (or failed to do) with regard to the information they had. The Senate Subcommittee conducting the investigation identified

more than a dozen red flags that should have caused the Enron Board to ask hard questions, examine Enron policies, and consider changing course. Those red flags were not heeded. In too many instances, by going along with questionable practices and relying on management and auditor representations, the Enron Board failed to provide the prudent oversight and checks and balances that its

41. See MARK S. BEASELY ET AL., COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, *FRAUDULENT FINANCIAL REPORTING: 1987–1997: AN ANALYSIS OF U.S. PUBLIC COMPANIES* 6 (1999). A number of legal commentators and economists, however, questioned whether the trend toward independent directors really improved corporate economic performance. See, e.g., Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 *BUS. LAW.* 921 (1999).

42. As noted above, stock exchange requirements as to independent directors were limited to those relating to audit committees. See *supra* note 11 and accompanying text.

fiduciary obligations required and a company like Enron needed.⁴³

The Subcommittee also noted the “lack of independence” of the outside directors due to “financial ties between the company and certain Board members.”⁴⁴

The criticism leveled at failed companies’ boards of directors did not have the effect of undermining the centrality of the board. On the contrary, the resulting federal and stock exchange rule-making focused instead on ensuring that the board of directors—and the independent directors in particular—could perform the central oversight role to which they were assigned. For example, the recommendations of the Senate Subcommittee report included the adoption of rules by the SEC and the stock exchanges of heightened independence requirements for directors, and confirmed the responsibilities of the board to oversee such matters as accounting practices, conflicts of interest, and executive compensation.⁴⁵

1. Stock Exchange Requirements

The recommendations of the Senate Subcommittee were consistent with concurrent developments at the SEC and the stock exchanges. In February 2002, SEC Chairman Harvey Pitt sent a letter to the NYSE and Nasdaq requesting that they review and enhance their corporate governance listing standards.⁴⁶ Both organizations were already in the process of doing so, and the enhanced standards that they proposed in 2002 and adopted in 2003 codified, standardized, and enhanced the composition and role of public company boards.⁴⁷

The NYSE’s governance changes arose from the June 2002 recommendations issued by its Corporate Accountability and Listing Standards Committee. The report of this committee

43. See PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE S. COMM. ON GOV’T AFFAIRS, 107TH CONG., REP. ON THE ROLE OF THE BOARD OF DIRECTORS IN ENRON’S COLLAPSE 55 (Comm. Print 2002) [hereinafter ENRON REPORT].

44. *Id.* at 51–52.

45. *Id.* at 4.

46. See Letter from Harvey L. Pitt, SEC Chairman, to Richard Grasso, Chairman and Chief Exec. Officer of the NYSE, and to Hardwick Simmons, Chairman and Chief Exec. Officer of Nasdaq (Feb. 12, 2002), in STANLEY KELLER, DISCLOSURE AND OTHER LESSONS LEARNED AFTER ENRON 285–86 (2002) (noting that the SEC is “actively considering ways to improve corporate disclosure, corporate governance and accounting quality, we believe that improvements in company listing standards regarding corporate governance can be achieved quickly and also give investors additional meaningful protection.”).

47. See NASD and NYSE Rulemaking: Relating to Corporate Governance, Exchange Act Release No. 48745, 81 SEC Docket 1586 (Nov. 4, 2003).

expressly took as its premise that the public company structure “depends upon the competence and integrity of corporate directors, as it is their responsibility to diligently oversee management while adhering to unimpeachable ethical standards.” The committee notes that it has “sought to strengthen checks and balances and give the legions of diligent directors better tools to empower them and encourage excellence.”⁴⁸

The revised NYSE and Nasdaq listing standards include a number of regulations specifically relating to the board of directors, including the following:

- *Requiring Majority Independent Boards.* All public companies (other than controlled companies and a few other excepted categories) must have boards that consist of a majority of independent directors.⁴⁹
- *Strengthening Independence Standards.* The revised NYSE and Nasdaq rules contained, for the first time, bright-line independence tests, which, if failed, would bar the board from deeming a director to be independent.⁵⁰
- *Executive Sessions.* NYSE and Nasdaq rules require that independent directors meet regularly in executive session, without management present.⁵¹ In addition, the NYSE rules require the company to disclose a means for interested parties to communicate with the independent directors.⁵²

48. N.Y. STOCK EXCH. CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMM. 1 (June 6, 2002) [hereinafter CALS REPORT], available at http://usequities.nyx.com/sites/corporate.nyx.com/files/corp_govreport.pdf.

49. The board is required to make an affirmative determination of the independence of any purportedly independent director. SEC rules adopted in 2006 require disclosure of the independence standards used by the board and of the categories of relationships considered by the board in assessing independence. See discussion *infra* Section II.C.3; see also 17 C.F.R. § 229.407(a) (2010).

50. These include prior employment with the company, receipt of specified levels of compensation other than director fees, business relationships between the company and director-affiliated companies, relationships between the director and the outside auditors, and compensation committee interlocks. These bright-line tests generally have a three-year “look-back” period and generally also encompass the director’s family members. See NYSE, N.Y. STOCK EXCH. LISTED CO. MANUAL § 303A.02 (2009); NASDAQ MANUAL § 5605(a)(2) (2011).

51. See NYSE, N.Y. STOCK EXCH. LISTED CO. MANUAL § 303A.03; NASDAQ MANUAL § 5605(b)(2) (2011). The NYSE rules state that the purpose of the executive sessions is to “empower non-management directors to serve as a more effective check on management.”

52. Nasdaq rules do not require this line of communication, although all listed companies will need to comply with the SEC requirement that the audit

- *Independent Audit Committees.* Although NYSE and Nasdaq rules already required independent audit committees,⁵³ the 2003 NYSE rule changes greatly expanded the responsibilities of the audit committee, going beyond the traditional area of auditor and financial reporting oversight, into such areas as legal and regulatory compliance and risk management.⁵⁴
- *Independent Compensation Committees.* Director oversight of executive compensation had long been viewed as a key instrument by which the board can act as a check on management.⁵⁵ The 2003 NYSE and Nasdaq rule changes required the independent directors to oversee the compensation of the CEO and other executives.⁵⁶

committee establish complaint procedures relating to accounting matters and with SEC disclosure requirements relating to shareholder communication with the board. See discussion *infra* Section II.C.3.

53. The initial NYSE and Nasdaq rules relating to audit committees, *supra* note 11, were most recently amended in 1999. The 1999 amendments grew out of the recommendations of the NYSE and NASD's Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, and generally required written audit committee charters, included more rigorous independence standards for audit committee members, and imposed financial literacy requirements for audit committee members. See NYSE Rulemaking: Order Approving Proposed Rule Change Amending the Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 & No. 2 Thereto, Exchange Act Release No. 42233, 64 Fed. Reg. 71,529 (Dec. 21, 1999); Self-Regulatory Organizations: Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. Amending Its Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 & No. 2 Thereto, Exchange Release No. 42231, 64 Fed. Reg. 71,523 (Dec. 21, 1999). Also in 1999, the SEC adopted new rules expanding proxy statement disclosure regarding audit committee composition and operations. See Audit Committee Disclosure, Exchange Act Release No. 42266, 64 Fed. Reg. 73,389 (Dec. 30, 1999).

54. See NYSE, N.Y. STOCK EXCH. LISTED CO. MANUAL §§ 303A.06, 303A.07 (2009). The 2003 Nasdaq rule changes required a fully independent board, but did not broaden the scope of audit committee responsibilities as extensively as the NYSE rules did. SOX imposed even greater restraints on financial ties between audit committee members and the company. See discussion *infra* Section II.C.2.

55. See, e.g., 2001 NACD REPORT, *supra* note 19, at 12 (executive compensation should be determined by a committee of independent directors).

56. See NYSE, N.Y. STOCK EXCH. LISTED CO. MANUAL § 303A.05 (2009) (requiring an independent compensation committee). Nasdaq rules require that executive officer compensation be determined by the independent directors as a group, whether or not they are functioning as a formal committee. See NASDAQ MANUAL § 5605(d) (2011). SEC rules that were proposed in 2011 under the Dodd-Frank Act may lead the exchanges to impose even higher independence standards for compensation committee members. See discussion *infra* Section II.C.3.

- *Independent Nominating and Corporate Governance Committees.* Consistent with best practices previously issued by private groups in the governance community,⁵⁷ the 2003 NYSE and Nasdaq rule changes placed the process of nominating board candidates in the hands of the independent directors.⁵⁸ The CALS Report to the NYSE indicated that having the independent directors perform this function can “enhance the independence and quality of nominees.”⁵⁹ More generally, this requirement was an effort to undercut the traditional criticism that the board is hand-picked by, and thus owes its loyalty to, the CEO.⁶⁰
- *Formal Governance Documents.* The NYSE 2003 rule changes significantly expanded the documentation and disclosure required with respect to board functions and composition, including the adoption and publication of committee charters and corporate governance guidelines.⁶¹ In addition, NYSE and Nasdaq companies are required to adopt and publish a code of business conduct and ethics that apply to directors (as well as employees) addressing areas such as conflicts of interest, and to publicize any waiver of the code for directors or executive officers.⁶²

The adoption of these requirements by the stock exchanges relating to the operations, qualifications, and independence of the board of directors had the intent, and the effect, of placing the board—and the independent directors in particular—more firmly at the center of the company’s governance system.

57. See, e.g., 2001 NACD Board Report, *supra* note 19, at 12 (indicating that boards should designate an independent committee, such as the nominating or governance committee to monitor board composition and operations); CALPERS, *supra* note 19, at 4–6 (stating that the board committee responsible for nominating directors should be entirely independent).

58. The 2003 NYSE rule changes require an independent nominating committee, while the Nasdaq rules require the independent directors, either as a group or as a formal committee, to oversee the process. See NYSE, N.Y. STOCK EXCH. LISTED CO. MANUAL § 303A.05 (2009); NASDAQ MANUAL § 5605(e).

59. CALS REPORT, *supra* note 48, at 9.

60. See, e.g., Statement of the Business Roundtable, *supra* note 13, at 2092 (noting this criticism of board independence).

61. These guidelines must be developed by an independent board committee, and must cover such areas as director qualifications and responsibilities, director compensation, director orientation and continuing education and annual board and committee performance reviews. See NYSE, N.Y. STOCK EXCH. LISTED CO. MANUAL § 303A.09 (2009).

62. *Id.* § 303A.10 (2009); NASDAQ MANUAL § 5610.

2. SOX Provisions

Although the bulk of the post-Enron regulation relating to the board of directors occurred at the stock exchange level, a number of SOX provisions further enhanced the independence and responsibilities of the board, including the following:

- *Prohibition on loans to directors.* SOX Section 402 prohibits a public company from making or arranging personal loans to directors or executive officers.⁶³
- *Audit committee independence and function.* The role of the audit committee was a key focus of the Congressional investigation into the Enron collapse,⁶⁴ and SOX contained several provisions that strengthened audit committee requirements. These included requiring listed companies to have fully independent audit committees with specified duties, including oversight of outside auditors and development of procedures for handling accounting-related complaints from employees and others.⁶⁵
- *Audit committee financial expert.* Rules promulgated under SOX Section 407 require U.S. companies to disclose whether or not they have at least one “audit committee financial expert” on their audit committee. The statute and the rules issued thereunder specify the attributes that

63. The legislative history behind this provision indicates that a number of prominent failed corporations, including Enron, WorldCom, and Adelphia, made significant personal loans to directors and executive officers. See PUB. CO. ACCOUNTING REFORM & INVESTOR PROTECTION ACT OF 2002, S. REP. NO. 107-205, at 29-30 (2002). Senator Feinstein noted in the floor debates on this provision that these loans “create[d] conflicts of interest that limit . . . the ability of outside directors, in particular, to voice their criticism of the institution.” 148 CONG. REC. 12,942 (July 15, 2002).

64. ENRON REPORT, *supra* note 43; see also U.S. GEN. ACCOUNTING OFFICE, GAO-02-494SP, HIGHLIGHTS OF GAO’S CORPORATE GOVERNANCE, TRANSPARENCY AND ACCOUNTABILITY FORUM 8 (2002) (indicating that audit committees will be most effective if they are “comprised of highly qualified individuals who are truly independent of top management”).

65. See 17 C.F.R. § 240.10A-3 (2011). Rule 10A-3 also requires that audit committees must have authority to engage independent advisors and must receive appropriate funding from the company. The independence standards of Rule 10A-3 are even more restrictive, in many ways, than the stock exchange standards, in that they prohibit certain director-affiliated entities from receiving even a *de minimis* amount of consulting fees from the company, and potentially prevent directors affiliated with large shareholders from serving on the audit committee.

a “financial expert” must have, and the rules set out the ways in which these attributes must have been gained.⁶⁶

- *Audit committee communications.* SOX also called for changes to auditing standards that would require the outside auditors to provide more information to audit committees, including critical accounting policies used, and alternative treatments that have been discussed with management. These changes were implemented through the adoption by the SEC of Rule 2-07 under Regulation S-X.⁶⁷

3. Post-Sarbanes-Oxley Regulatory Developments

Regulatory developments following the enactment of SOX and the concurrent stock exchange rule changes continued to place an emphasis on the importance of a strong and active board of directors, including the following:

- *Sentencing guidelines.* In 2004, the U.S. Sentencing Commission amended the U.S. Sentencing Guidelines to tighten the requirements for corporate compliance and ethics programs, including requiring greater involvement of the board of directors. The Commission indicated that the “focus on ethical corporate behavior in this amendment reflects a shift in the legal landscape” and noted that SOX had “adopted ethics as a guiding principle.”⁶⁸ Among the new criteria for leniency under the sentencing guidelines is a requirement that the company have a board of directors that is knowledgeable about and oversees the corporate compliance program, and that the indi-

66. See 17 C.F.R. § 229.407(d)(5) (2011). This requirement arose from the view that certain of the prominent corporate failures could have been prevented had the audit committees had greater expertise to bring to bear in overseeing the companies’ financial reporting practices. See S. REP. NO. 107-205, at 23, 32 (2002).

67. In 2010, the Public Company Accounting Oversight Board (“PCAOB”) proposed rule amendments that would expand communications between the auditors and the audit committee even further. See PCAOB, PROPOSED AUDITING STANDARD RELATED TO COMMUNICATIONS WITH AUDIT COMMITTEES AND RELATED AMENDMENTS TO CERTAIN PCAOB AUDITING STANDARDS (2010).

68. Press Release, U.S. Sentencing Comm’n, Commission Tightens Requirements for Corporate Compliance and Ethics Programs (May 3, 2004), available at http://www.uscc.gov/Legislative_and_Public_Affairs/Newsroom/Press_Releases/20040503_Press_Release.htm.

viduals who manage the program on a day-to-day basis have direct access to the board of directors.⁶⁹

- *SEC board-related disclosure requirements.* In years subsequent to SOX, the SEC has continued to expand its disclosure requirements in a manner that has emphasized the central role of the board. For example, in 2006, the SEC consolidated and expanded the proxy disclosure requirements relating to board composition and practices.⁷⁰ Some of the expanded disclosures that have been consolidated under Item 407 of Regulation S-K are the following:
 - Identification of independent directors, and disclosure of the company's definition of independence.⁷¹
 - Disclosure as to the composition and charters of the company's audit, compensation, or nominating committees, including the identity of any non-independent directors on the committee.⁷²
 - Description, by category or type, of the relationships between directors and the company that the board considered in assessing independence.⁷³
 - Disclosure regarding director attendance at board and committee meetings and annual meetings.⁷⁴
 - Description of processes for shareholders to send communications to the board of directors (or, if there is none, the reason the board thinks it is appropriate not to have one).⁷⁵
 - Description of the scope and authority of the compensation committee, and the processes and procedures by which the compensation committee considers executive compensation and director compensation.⁷⁶
 - Disclosure of the nominating committee process, including any minimum qualifications necessary for

69. U.S. SENTENCING COMM'N, GUIDELINES MANUAL § 8B2.1(b)(2) (2004).

70. See Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732A, Exchange Act Release No. 542302A, Investment Company Act Release No. 27444A, 71 Fed. Reg. 53,158 (Aug. 29, 2006).

71. See 17 C.F.R. § 229.407(a) (2011).

72. See 17 C.F.R. § 229.407(b)(3).

73. See 17 C.F.R. § 229.407(a)(3).

74. See 17 C.F.R. § 229.407(b).

75. See 17 C.F.R. § 229.407(f).

76. See 17 C.F.R. § 229.407(e).

directors, the committee's evaluation process, and the category of person that was the source for each director nominee.⁷⁷

The 2006 rule changes also amended the disclosure rules under Item 404 of Regulation S-K concerning related party transactions—particularly as the rules related to business relationships between the company and a director-affiliated entity—and required disclosure of the company's policies and procedures for reviewing and approving related party transactions (including the individuals on the board of directors or otherwise who are responsible for applying the policies and procedures).

SEC rule changes adopted in December 2009 continue this board-related focus by requiring a description of the specific experience, qualifications, attributes, or skills that justify the nomination of each director,⁷⁸ as well as a description of the board's diversity policy.⁷⁹ The December 2009 revisions also require disclosure as to the board leadership structure, including whether the company has separated the positions of the CEO and chairman of the board, whether the company has a lead independent director and, in each case, why, and how the board implements and manages its risk management function.⁸⁰

- *Dodd-Frank requirements.* The emphasis on the power and authority of independent directors has continued in recent legislation. In 2011, as required by Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"),⁸¹ the SEC proposed rules that would direct the stock exchanges to enhance their compensation committee independence requirements.⁸²

77. See 17 C.F.R. § 229.407(c).

78. See 17 C.F.R. § 229.401(e)(1). The December 2009 changes were adopted in Proxy Disclosure Enhancements, Securities Act Release No. 9089, Exchange Act Release No. 61175, Investment Company Act Release No. 29092, 74 Fed. Reg. 68,334 (Dec. 23, 2009).

79. See 17 C.F.R. § 229.407(c)(2)(vi).

80. See 17 C.F.R. § 229.407(h).

81. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 12 U.S.C.).

82. See Listing Standards for Compensation Committees, Securities Act Release No. 9199, Exchange Act Release No. 64149, 76 Fed. Reg. 18,966 (proposed Apr. 6, 2011).

In addition, Section 952 of the Dodd-Frank Act and the proposed rules require that compensation committees have appropriate funding and authority to retain advisors, and require expanded disclosure regarding compensation committee processes, including the use and independence of advisors.

4. Protection of Shareholder Interests

A fundamental goal of the strengthening of the board during the past forty years has been the protection of the interests of shareholders. At the same time, the role of shareholders in selecting the board has been enhanced by, among other things, facilitating shareholders' ability to elect directors, expanding disclosure relating to board functions, directors and nominees, and providing means for shareholders to communicate with the board. As described in the following paragraphs, these approaches are mutually complementary and support the dominant paradigm of a strong, central board of directors elected by a well-informed shareholder base.

- *Stronger boards.* Protection of the shareholder interests has been a primary goal of the strengthening of the role of the board. The SEC reports on Penn Central and Stirling Homex in the 1970s expressly commented on the failure of the respective boards to protect shareholder interests.⁸³ The various post-mortems and legislative and regulatory efforts following Enron made clear that the ultimate objective for expanding the role of the independent directors was to protect investors.⁸⁴ This approach—enhanc-

83. Stirling Homex Report, *supra* note 7, at 5 (“[The] directors, in the opinion of the Commission, did not provide the shareholders with any significant [p]rotection.”); PENN CENTRAL REPORT, *supra* note 3, at 151 (“As a practical matter, shareholders can rely only on the outside directors to oversee management.”).

84. See, e.g., *The Role of the Board of Directors in Enron’s Collapse: Hearing Before the Permanent Subcomm. of Investigations of the Comm. on Gov’t Affairs*, 107th Cong. 1 (2002) (statement of Sen. Carl Levin, Chairman, Permanent Subcomm. on Investigations) (“Directors are charged by law to be the fiduciaries, the trustees who protect the interests of the corporate shareholders.”). Similarly, Senator Collins stated that “Corporate boards play an essential role in the American economy. They are the single most important guardians of a company’s shareholders” *Id.* at 6 (statement of Sen. Susan Collins, Permanent Subcomm. on Investigations). The Enron Report states that the board’s “paramount duty” is to safeguard the interests of shareholders. ENRON REPORT, *supra* note 43, at 5 (citing BUSINESS ROUNDTABLE, *supra* note 19); see also U.S. GEN. ACCOUNTING OFFICE, *supra* note 64, at 7 (“Boards of directors, including audit committees, work for the shareholders”).

ing shareholder protection by empowering the independent directors—is certainly consistent with the director’s fundamental obligations as a state law matter to protect the interests of shareholders.

- *Structure of corporate elections.* The mid-2000s saw a significant change in corporate governance practices of public companies as they relate to the election of directors. The cumulative effect of these changes has generally been to increase shareholder influence over the selection of a company’s directors. One example is the decline in classified boards—this structure is much less common than it was ten years ago, and annual election of directors is now the norm among larger public companies.⁸⁵ The removal of a classified board structure means that shareholders have the ability to vote on the full board (and potentially to vote out the full board) in a single shareholder meeting. In addition, under the laws of many states, including Delaware, the elimination of a classified board structure means that directors may be removed without cause, which further increases shareholder control over board composition.⁸⁶

Second, within the last decade, most large public companies have adopted majority voting provisions, whereby an affirmative majority of votes cast in favor of a director, rather than a mere plurality of votes, is necessary for the election of that director in an uncontested election.⁸⁷ In an uncontested election, there are the same number of nominees as there are open seats, and so all directors will automatically obtain a plurality of the votes. In contrast, majority voting provisions give shareholders the ability to utilize withhold vote⁸⁸ campaigns to block the election of nominees on the management slate, and

85. See, e.g., THEODORE N. MIRVIS, TAKEOVER LAW AND PRACTICE 556–57 (2010); SHEARMAN & STERLING LLP, CORPORATE GOVERNANCE OF THE LARGEST U.S. PUBLIC COMPANIES: GENERAL GOVERNANCE PRACTICES (2010) (each summarizing the recent decline in classified boards).

86. See Del. Code Ann. tit. 8, § 141(k)(1) (Supp. 2010).

87. See MIRVIS, *supra* note 85; SHEARMAN & STERLING LLP, *supra* note 85 (each summarizing the increased prevalence of majority voting in recent years). Majority voting bylaw provisions are typically accompanied by a director resignation bylaw or policy, whereby an incumbent director who fails to receive more “for” than “against” votes will submit his or her resignation to the board for consideration, and the board will typically be obligated to publicize its decision.

88. These recommendations are variously styled as “withhold vote” or “vote no” campaigns, because a particular corporation’s form of proxy may or may not give a shareholder the opportunity to vote “against” a particular nomi-

potentially increase the impact of a withhold vote recommendation by a proxy advisory firm.

Other examples of changes in common governance practices that have provided shareholders with increased control over director elections include the right of shareholders to call special meetings and the right of shareholders to act by written consent, both of which can be used to mount an election contest outside the annual meeting context. Shareholder proposals urging companies to adopt these rights have been common in recent years and a number of public companies have reacted by providing shareholders with these rights (subject to limitations), although concerns about their potential impact as a takeover mechanism have limited their appeal to many companies and shareholder groups.⁸⁹

Finally, under recent SEC rule changes, shareholders are now able to use Rule 14a-8 to propose proxy access bylaws and other election or nomination procedures, setting the stage for expanded rights of shareholders to include their own nominees in the company's proxy materials. The SEC had adopted a uniform, mandatory proxy access rule, Rule 14a-11, in August 2010, but this rule was vacated by the U.S. Court of Appeals for the D.C. Circuit following review of a legal challenge to the rulemaking.⁹⁰ However, the SEC's concurrent changes to Rule 14a-8(i)(8) were not litigated, and went into effect in September 2011. Under Rule 14a-8(i)(8), as revised, companies must permit shareholder proposals that either request that the board implement proxy access or that bypass the board and directly amend the company's bylaws to implement proxy access. It remains to be seen whether proxy access will become common among public companies in the way that majority voting has.⁹¹ But, in

nee rather than "withhold" the vote. See 17 C.F.R. § 240.14a-4 (2011) (instruction 2). We use the term "withhold vote" in this article for convenience.

89. For a further discussion of shareholder proposals relating to special meetings and action by written consent, see 1 JOHN T. BOSTELMAN, ROBERT E. BUCKHOLZ, JR. & MARC R. TREVINO, PUBLIC COMPANY DESKBOOK: SARBANES-OXLEY AND FEDERAL GOVERNANCE REQUIREMENTS § 15:4.1 (2d ed. 2011). See also SHEARMAN & STERLING LLP, *supra* note 85.

90. See *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

91. Companies and shareholders may determine that a proxy access regime would undermine the role of the nominating committee, and that a combination of a strong, independent nominating committee, effective shareholder communication channels, and majority voting provisions makes proxy access unnecessary and undesirable.

any event, the ability of shareholders to use the company's proxy materials to propose changes to the company's election process, including proxy access provisions, represents a further increase in shareholder influence over director elections.

Views may differ on whether these developments ultimately work toward the long-term benefit of shareholders, but all these developments enhance shareholders' exercise of their traditional rights to elect directors. At the same time, however, none of them provides shareholders with an enhanced ability to participate directly in the management of the company's business and affairs. They are, as a general matter, consistent with the trend toward a strong and independent board of directors—they relate to the manner in which shareholders elect the directors, but do not undermine the centrality of the board of directors as the ultimate authority with respect to the company's business practices.

- *Expanded disclosure.* The discussion in Section II.C.3, above, provides examples of how the SEC has sought to protect shareholder interests by requiring expanded disclosure of corporate governance matters, rather than directly mandating particular structures or practices. This approach is consistent with the general mandate of the SEC as it relates to proxy disclosure and financial reporting, which is largely limited to disclosure matters.⁹²

Congress and the SEC have taken a similar disclosure-based approach in areas of social policy. For example, the Dodd-Frank Act directs the SEC to issue rules requiring disclosure of a company's use of certain minerals that have been determined by the U.S. Secretary of State to be financing conflict in the Democratic Republic of the Congo.⁹³ The Dodd-Frank Act also provides that any U.S.

92. See *Bus. Roundtable v. SEC*, 905 F.2d 406, 410 (D.C. Cir. 1990). The court in that case invalidated an SEC rule compelling the stock exchanges to prohibit listed companies from issuing a class of multi-vote stock, holding that it went beyond the SEC's disclosure-related authority under Section 19 of the Exchange Act. The opinion cited the legislative history of Section 19 for the proposition that the purpose of the proxy protections is to ensure that shareholders have adequate knowledge about the financial condition of the company and the major questions of policy that are decided at shareholders' meetings.

93. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1502, 124 Stat. 1376, 2213 (2010). This provision is based on the concerns that the exploitation and trade in these materials is con-

public company that operates a coal or other mine must include in its SEC filings detailed information regarding the safety record of each mine and related matters.⁹⁴ For many years, the SEC has imposed more extensive disclosure requirements for environmental regulatory proceedings than would be required for other regulatory proceedings—requiring disclosure of, among other things, any matter that may reasonably result in monetary sanctions of \$100,000 or more.⁹⁵

- *Shareholder communication with the board.* Another way in which regulatory and governance developments have protected shareholder interests is the facilitation of communication between shareholders and the board. As noted in Section II.C.1, above, the NYSE listing standards adopted in 2003 require the disclosure of a means for interested parties to communicate with independent directors, the SEC proxy rules require disclosure of a process for shareholders to send communications to the board of directors (or, if there is none, the reason the board thinks it is appropriate not to have one), and Rule 10A-3 under the Exchange Act requires the audit committee to put in place procedures for the review of accounting-related complaints expressed by shareholders or others. It is noteworthy that these measures all relate to communications from shareholders to the board, but do not require the board to respond to or meet with shareholders. These measures do not increase the power of shareholders in relation to the board as to the matters communicated, but are consistent with the movement toward a stronger board of directors in that they ensure that the board has alternate sources of information and views.

The examples discussed in this Section illustrate that regulators and the governance community have been

contributing to an emergency humanitarian situation in the Democratic Republic of the Congo.

94. *Id.* § 1503.

95. See 17 C.F.R. § 229.103 (2011). The SEC adopted these provisions in 1971, indicating in the proposing release that its approach to environmental disclosure reflects its “recognition of the importance of environmental information to informed investment and voting decisions, and the unique mandate to consider the environment which was imposed on all federal agencies by the [National Environmental Policy Act]”. Proposed Amendments to Item 5 of Regulation S-K Regarding Disclosure of Certain Environmental Proceedings, Securities Act Release No. 6315, Exchange Act Release No. 17762, 46 Fed. Reg. 25,638 (May 8, 1981).

deeply concerned with investor protection, but, outside of the Rule 14a-8 context, generally did not seek to implement this protection by allowing shareholders to participate directly in management or social policy decisions. Instead, the focus has been on empowering the board of directors and facilitating the shareholders' role in director elections, as well as ensuring that shareholders have access to sufficient information about corporate matters in exercising their traditional rights to elect directors and make investment decisions.

D. *Analysis of Governance Developments Under Various Theories of the Firm*

As illustrated by the above discussion, over the past forty years, we witnessed a dramatic change in the balance of power within U.S. public companies, reflecting an increase in the authority, responsibility, and autonomy of the board of directors, and independent directors in particular, in relation to management. As discussed further below, this development reflects the adoption of a director-centric application of the contractarian legal theory of corporations. This theory conceptualizes the corporation as a nexus of contracts among various stakeholders, with the board at that intersection.⁹⁶ It differs from the so-called "ownership" theory of the corporation, in which the shareholders are seen as the owners of the corporation, and the directors and officers are seen as merely their agents. As discussed in Section III.D, below, this latter view seems to underlie the broad application of Rule 14a-8, particularly for social policy proposals, but is otherwise inconsistent with the governance shift toward board centrality.

1. The Invalidity of the Traditional Ownership Theory of the Corporation

The "theory of the corporation" has long been a focus of attention and debate among legal scholars, from both a positive standpoint (how are corporations viewed under current law and practice) and a normative standpoint (what *should* be the relationship among corporate stakeholders). According to the most

96. For a discussion of the contractarian theory of the corporation, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991). For a discussion of the director primacy approach in particular, see Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. REV. 547 (2003). This approach is discussed further in Section II.D.2 below.

traditional “ownership” view of the corporation, the shareholders are the owners of the entity from a standard private property standpoint, and the directors and management are their mere agents, appointed to manage the business on the shareholders’ behalf.⁹⁷ It has long been observed by legal scholars, however, that the actual nature of the director/shareholder relationship presents difficulties for this theory.⁹⁸ Under traditional agency law, the agent does not use its own discretion in acting on behalf of the principal. Rather, the principal must *control* (or, in any event, have the power to control) the agent in a way that shareholders are not able to control directors.⁹⁹ This element of shareholder control over the board is, however, lacking as a legal and a practical matter.

State corporate law almost invariably vests the power to manage the business and affairs of the corporation in the board of directors directly, not the shareholders.¹⁰⁰ The limited exceptions to this general rule (other than those that may be provided for in a particular company’s certificate of incorporation) are such fundamental rights as electing and removing directors,¹⁰¹ approval of a limited number of transformational corporate transactions,¹⁰² the right (also typically held by the board) to amend corporate bylaws,¹⁰³ and the joint right (with the board) to approve amendments to the certificate of incorporation.¹⁰⁴ For listed companies, shareholder approval is also needed for certain potentially dilutive events, including the issuance of shares that represent more than 20% of the company’s equity or

97. See, e.g., E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1145 (1932); Friedman, *supra* note 34.

98. See, for example, Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, at 451–67 (2006) for a further discussion of the deficiencies of the view of directors as agents.

99. See RESTATEMENT (THIRD) OF AGENCY §1.01 (2006) (“Agency is the fiduciary relationship that arises when one person (a ‘principal’) manifests assent to another person (an ‘agent’) that the agent shall act on the principal’s behalf *and subject to the principal’s control*, and the agent manifests or otherwise consents so to act.”) (emphasis added).

100. See, e.g., DEL. CODE ANN. tit. 8, § 141 (2001 & Supp. 2010); N.Y. BUS. CORP. LAW §701 (McKinney 2011).

101. See, e.g., DEL. CODE ANN. tit. 8, § 216 (Supp. 2010) (addressing voting); DEL. CODE ANN. tit. 8, § 141(k) (Supp. 2010) (addressing removal).

102. Under Delaware law, these include mergers, DEL. CODE ANN. tit. 8, § 251(c) (Supp. 2010), sales of all or substantially all corporate assets, *id.* at § 271 (2001 & Supp. 2010), and dissolution, *id.* § 275 (2001 & Supp. 2010).

103. See *id.* § 109 (2001 & Supp. 2010).

104. See *id.* § 242 (2001 & Supp. 2010).

that will result in a change of control, or the adoption or material amendment of an equity compensation plan.¹⁰⁵

State courts have long rejected the view of directors as mere agents of the shareholders. As early as 1859, a New York court stated that, in contrast to an agency relationship, “in corporate bodies the powers of the board of directors are, in a very important sense, original and undelegated” and that “stockholders do not confer, nor can they revoke those powers.”¹⁰⁶ In 1924, the Delaware Supreme Court stated the point as follows:

In this state the general corporation law . . . provides that the directors shall manage the business of every corporation created under that law. The stockholders are without authority to do this. How can it be said that in performing this managerial duty for the corporation the directors act as agents?¹⁰⁷

Delaware courts have expressly confirmed that directors are not obligated to follow the wishes of even the holders of a majority of shares.¹⁰⁸ In fact, the courts explicitly prohibit the board from delegating its duties to shareholders.¹⁰⁹

The understanding that shareholders do not have the ability to direct the actions of the board is reflected in other respects in the SEC rules and the SEC staff’s administration of the Rule 14a-8 shareholder proposal process. The approach of the SEC and its staff reflects the general understanding that, if a proposal would bind the board of directors to a particular action, without enabling the board to exercise its discretion, then the proposal may be excluded as contrary to state law. In contrast, a precatory

105. See NYSE, N.Y. STOCK EXCH. LISTED CO. MANUAL § 303A.08 (2009); N.Y. STOCK EXCH., LISTED CO. MANUAL § 312.03 (2007); NASDAQ, NASDAQ STOCK MARKET RULE 5635 (2011).

106. *Hoyt v. Thompson’s Ex’r*, 19 N.Y. 207, 215 (1859).

107. *Northern Assurance Co. v. Rachlin Clothes Shop*, 125 A. 184, 188-89 (Del. 1924). The court cites *Hoyt*, 19 N.Y. at 216, on the “original and undelegated” nature of the board’s powers, and cites a number of other cases that speak to the “distinction between the acts of an individual acting as agent for a corporation and the acts of persons who in the exercise of undelegated powers act in the primary role of the corporation itself.” See also *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) (“A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.”).

108. *Paramount Commc’ns Inc. v. Time Inc.*, No. 10866, 1989 WL 79880, at *30 (Del. Ch. July 14, 1989), *aff’d*, 571 A.2d 1140 (Del. 1989) (“The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares.”).

109. *Paramount Commc’ns Inc.*, 571 A.2d at 1154.

proposal that merely requests the board to take certain actions would typically not be excludable on this basis. The SEC added an express instruction to Rule 14a-8(i)(1) to this effect in 1976.¹¹⁰

2. Contractarian Theory

The more modern contractarian theory of the corporation began to take shape upon the 1937 publication of Ronald Coase's article, *The Nature of the Firm*.¹¹¹ Coase addressed the question of why corporations are the prevalent form of business operation, as opposed to individual actors who contract with one another. Coase posited that the corporate form improved efficiency through the elimination of transaction costs that would otherwise exist. This view of corporations as akin to markets, and thus susceptible to traditional economic theory, was the basis over subsequent decades for the development of the contractarian, or law-and-economics, view of corporate governance. The contractarian view has become the prevalent view of corporate structure, and is generally supported by the flexibility that corporations have as a state law matter with regard to governance structure, and by the diversity of governance structures that exist among public and private corporations.¹¹²

The contractarian view does not itself suggest the appropriate balance of power among shareholders, directors, and management and other stakeholders, but merely posits that the various stakeholders agree upon the balance through determination of the state of incorporation and the provisions of the governing documents.¹¹³ For U.S. public companies, however, the contractual relationships among the various corporate stakeholders are not negotiated in a vacuum. The contractarian view acknowledges the need for the law to provide default rules from which corporate actors may have some choice to depart,¹¹⁴ but the pull of default rules as to governance—whether in the form of regulations or best practices—is particularly strong for public

110. See Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12999, Investment Company Act Release No. 9539, 41 Fed. Reg. 52,994 (Dec. 3, 1976).

111. R. H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

112. See EASTERBROOK & FISCHEL, *supra* note 96, at 12–13 (noting that, consistent with the contractarian view, corporate structures are “wonderfully diverse, matching the diversity of economic activity carried on within corporations.”). *But see* Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 *J. CORP. L.* 779, 794 (2006) (noting a general lack of unique customized charter provisions on key governance matters).

113. See EASTERBROOK & FISCHEL, *supra* note 96, at 17–19.

114. See *id.* at 34–35.

companies. The combination of state corporate law, federal disclosure requirements, stock exchange listing standards, investor relations concerns, shareholder activism, and developing best practices has, over the past several decades, pushed U.S. public companies toward a structure that (a) emphasizes the central role of the board of directors, and particularly independent directors, and (b) protects shareholder interests in the ongoing management of the business primarily through the shareholders' right to elect, and to communicate with, the board of directors, together with the imposition of fiduciary duties on directors.

The rise in power of the board of directors can be seen as an instance of the contractarian view in action. Under this view, public shareholders began to place higher value on companies with strong independent boards because the shareholders believed that the board's oversight would counteract the potential for management excesses arising from the separation of ownership and control. The legal, regulatory, and industry developments over past decades have created a powerful set of default governance standards for public companies, and the attractive force of these default standards—including a desire by public companies not to be seen as in the “back of the pack” in governance practices—have worked to compel public companies generally to adopt a model of a powerful, independent, and autonomous board of directors. The various waves of corporate failures and scandals gave management, too, an incentive to accept greater board oversight and autonomy, both for investor relations purposes and also for its stabilizing effect on the company (certainly the management and employees of companies involved in corporate meltdowns fare poorly and, in some cases, disastrously).

The widespread adoption of this director-centric governance model is the culmination of decades of legal and regulatory actions, shareholder demands, business exigencies, and calls for action from multiple sources. This model can fairly be referred to now as the paradigm for corporate governance and the frontline defense in protecting investors, other corporate stakeholders, and society more broadly from the effects of corporate misbehavior.

A refinement of the contractarian model that helps explain, and justify, the expanded role of the board of directors is the concept of “director primacy,” introduced by Stephen Bainbridge in 2003.¹¹⁵ This model adopts the general view of the corporation as a nexus of contractual arrangements, but suggests

115. See Bainbridge, *supra* note 96.

that the board of directors occupies a special position—not merely as another stakeholder with interests that can be bargained for or given up, but essentially as the embodiment of the corporation itself. Essentially, the board is seen as “a *sui generis* body serving as the nexus for the various contracts making up the corporation and whose powers flow not from shareholders alone, but from the complete set of contracts constituting the firm.”¹¹⁶ This view has the benefit of consistency with the state law view of the board as having “original and undelegated” powers, as well as the general governance trend toward board empowerment described in this Part, above.¹¹⁷

3. Social Responsibility Theory

We see from the foregoing that, consistent with Professor Bainbridge’s director primacy theory, a combination of legal and regulatory initiatives, industry best practices, state court judicial interpretations, and shareholder pressure have shifted governance practices toward a more powerful and autonomous board of directors. This means not just that the board is no longer beholden to management, but also that (outside the Rule 14a-8 context) the board is largely free from direct interference from shareholders as to how it oversees the company, although of course shareholders possess the ultimate power to elect directors. Indeed, the enhanced power of the board can be justified by the enhanced role of the shareholders in the election process. Once elected, however, directors are clearly not mere agents of shareholders, and are not subject to their control except in certain statutorily identified circumstances.

One feature of corporate law, however, that has not changed from the traditional view—and that is expressly retained in the basic contractarian approach¹¹⁸ as well as Professor Bainbridge’s director primacy refinement¹¹⁹—is the idea that the directors must focus on maximizing shareholder wealth. When it comes to the social policy implications of the company’s actions, this raises the question, from a normative perspective, as to whether this is the correct governance structure to have adopted. Can the wealth maximization imperative be seen as driving the board to harm society and other stakeholders (employees, creditors, counterparties, etc.) for the benefit of shareholders? If the existing shareholders—or some influential subset of them—

116. *Id.* at 560.

117. *See supra* Section II.A–C.

118. *See* EASTERBROOK & FISCHER, *supra* note 96, at 37–39.

119. *See* Bainbridge, *supra* note 96, at 583.

would be willing to give up economic benefit for an alternate socially responsible path, should the board take this into account?

These are among the questions raised by proponents of the social responsibility theories of corporate law.¹²⁰ A comprehensive discussion of the benefits and challenges of social responsibility theories is beyond the scope of this Article. For our purposes we need only observe that social responsibility theory has not, as a descriptive matter, been the driver of the governance reforms in recent decades. The rhetoric behind these governance changes has been dominated by references to “investor protection” and “the interests of shareholders.”¹²¹ Legislators, regulators, and others who have driven these changes do refer, at times, to the public policy implications and broader societal impact of corporate governance failures, but even in these cases the focus is typically on the “investing public,” either expressly or implicitly.¹²² Where legislators have sought to address policy concerns other than shareholder interests, the policy solution has not been focused on additional board responsibilities.¹²³ The board has been seen as the mechanism to protect shareholders, not to protect other stakeholders or society more broadly (except to the extent their interests are aligned with those of shareholders). Boards have been subject to criticism for harming the public interest by insufficiently protecting shareholders—not for harming the public interest by protecting shareholders too much.

Of course, the fact that social responsibility theory has not driven the governance reforms to date does not resolve the question of whether it *should* drive reforms. If the empowerment of the board, and the paradigm of shareholder wealth maximization, have a socially harmful effect, then it may be appropriate for regulators or the governance community to contemplate appropriate changes. The relevant questions, for purposes of this Article, are (a) whether the governance shift described in

120. See Velasco, *supra* note 98, at 451–67 for a discussion of the various incarnations of social responsibility theory and their interplay with the traditional and contractarian theories.

121. See *supra* Section II.C.4.

122. See, e.g., ENRON REPORT, *supra* note 43, at 5 (noting the Board’s responsibility as to the fair presentation of financial information to the company’s “shareholders and the investing public.”).

123. For example, the SEC’s Penn Central Report does identify broader “public interest” concerns arising from the failure of the company, given its central role in the country’s infrastructure, but the proposed solutions to address these concerns relate to direct regulatory changes rather than governance related concerns. See PENN CENTRAL REPORT, *supra* note 3, at iii-vi.

Part II toward a strong, autonomous, independent board charged with maximizing long-term shareholder wealth reduces the likelihood that the company will act in a socially responsible manner; and (b) whether allowing direct shareholder involvement in the corporation's social policy decisions is a solution to this problem.

The first of these questions is discussed in Section II.B.4. The answer seems to be “no” (or at least “it should not”). Delaware case law does not, as a practical matter, seem to present a significant obstacle to the board's consideration of the social and moral implications of the company's actions. It is difficult to conceive of a reasonable action taken by a disinterested board to address such a social or moral implication that could not be seen as ultimately working to the benefit of shareholders—whether in terms of the company's reputation, long-term sustainability, community relations, ability to attract and retain employees, or otherwise. In states with constituency statutes, this is even more clearly the case.

From a social responsibility standpoint, this leaves the question of whether direct shareholder involvement in the company's actions is nevertheless helpful, as an additive measure, in causing the company to act in a more socially responsible manner. As discussed in Part V below, we believe that direct shareholder involvement will not necessarily have this effect.

III. A HISTORY OF SOCIAL POLICY PROPOSALS UNDER RULE 14A-8

As indicated above, the use of a strong board of directors has arisen as the preferred solution to the perennial problem associated with the separation of ownership and control within public corporations. This model has received broad regulatory, judicial, corporate, shareholder, and legal support as an appropriate mechanism to protect shareholder interests while preserving managerial flexibility.

One recent trend that runs counter to this model is the use by activist shareholders of the federal proxy process to seek to influence directly corporate actions that are perceived to have social policy implications.¹²⁴ Moreover, this avenue for share-

124. We focus in this Article on the use of Rule 14a-8 to advance shareholder proposals on social policy issues, because that is the current mechanism being used for direct shareholder involvement in the management of a corporation's affairs. Some in the legal and governance community have advocated a further expansion of direct shareholder involvement in corporate social policy decisions, necessarily entailing a more limited role for the board. *See, e.g.,* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?*, 124 HARV. L. REV. 83 (2010) (proposing rules giving shareholders a

holder involvement appears to have been rendered unnecessary by the board-related governance developments described above. Nonetheless, the increasing prevalence of social policy shareholder proposals, combined with the policies and influence of proxy advisory firms and the widespread adoption of majority voting provisions, will present directors with conflicts of interest that undermine the independence and judgment for which they were selected, as discussed in Part IV, below.

A. *Adoption and Early Development of the Shareholder Proposal Rule*

The treatment of social policy proposals has been a matter of controversy—and a dilemma for the SEC and its staff—throughout the history of the SEC shareholder proposal rules. In 1940, the SEC first required companies to give proxy recipients a means to vote on matters expected to be raised, whether or not by management, at the annual meeting.¹²⁵ In 1942, the SEC adopted a more formal requirement—Rule 14a-7, the predecessor to Rule 14a-8—requiring companies to include shareholder proposals in their proxy materials. The only exception available concerned proposals that were not “a proper subject for action by the security holders.”¹²⁶

This, of course, did not provide much guidance as to application. The question promptly arose as to whether a proposal raising social policy concerns was a “proper subject” for shareholder action. In 1945, the SEC addressed the question in a release, stating that the rule was not intended “to permit stockholders to obtain the consensus of other stockholders with respect to matters that are of a general political, social or economic nature” and that “[o]ther forums exist for the presentation of such views.” Therefore, the SEC stated, such matters are not “proper subjects” for shareholder action.¹²⁷

This interpretation was codified in 1952, when the rule (now renumbered as Rule 14a-8) was amended to allow companies to exclude a proposal if it “clearly appears that the proposal is submitted by the security holder primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes.”¹²⁸ This formulation presented two interrelated

direct role in determining the amounts and targets of corporate political spending).

125. See Exchange Act Release No. 2376, 1940 WL 7144 (Jan. 12, 1940).

126. See Securities Act Release No. 2887, Exchange Act Release No. 3347, Investment Company Act Release No. 417, 1942 WL 34864 (Dec. 18, 1942).

127. See Exchange Act Release No. 3638, Investment Company Act Release No. 735, 1945 WL 27415 (Jan. 3, 1945).

128. See Exchange Act Release No. 4775, 1952 WL 5254 (Dec. 11, 1952).

interpretive difficulties. First, it requires an assessment of the proponent's "purpose"—a necessarily subjective analysis. Second, it requires an assessment as to whether this purpose is to promote a "general" social cause—as distinct from a cause relating to the company in particular. In any event, it is notable that the SEC's first approach to social policy proposals under this standard was expressly to allow companies to exclude them—a position that stands in contrast to the most recent treatment.

In 1954, the SEC first adopted the "ordinary business" exclusion that would become the primary battleground for social policy considerations in subsequent years. The formulation was that a proposal could be excluded if it "consists of a recommendation or request that the management take action with respect to a matter relating to the conduct of the ordinary business operations of the issuer."¹²⁹ This exclusion, and the SEC staff's application of the exclusion, did not address whether social policy proposals were related to "ordinary business operations." It was not necessary to address this question because of the separate express exclusion for general social policy proposals.

This changed in 1972, however, when the SEC's express exclusion for social policy proposals was significantly narrowed. Rather than a broad exclusion for proposals that were primarily for the promotion of general social causes, the rule was amended to cover only social policies that were "not significantly related to the business of the issuer or . . . not in the control of the issuer." The SEC stated that this change was intended to remove the subjective elements of the analysis (i.e., the "purpose" of the proponent), and to provide objective standards "and thereby create greater certainty in the application of the rule."¹³⁰ These changes made it more difficult for companies to exclude shareholder proposals than under the prior standard.¹³¹

129. See Exchange Act Release No. 4979, 1954 WL 5772 (Jan. 6, 1954), 19 Fed. Reg. 246 (1954).

130. See Exchange Act Release No. 9784, Investment Company Act Release No 7375 (Sept. 22, 1972), 37 Fed. Reg. 23,178 (Oct. 31, 1972). A few years later, in 1976, this rule was further amended to remove references to social policies entirely—elements of the rule remained (i.e., lack of relevance to the issuer, lack of issuer control), but were made to apply more generally. See Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12999, Investment Company Act Release No. 9539, 41 Fed. Reg. 52,994 (Dec. 3, 1976). The SEC indicated that the reason for this change was that, given the 1972 changes, the "illustrative reference to various general causes have been deleted on the ground they are superfluous and unnecessary." *Id.* at 52,997.

131. If a social policy proposal really has no meaningful connection to the company at all, the company could (and still can) exclude the proposal

With the narrowing of the exclusion for social policy proposals in 1972, the analysis shifted to the scope of the ordinary business exclusion: companies argued that social policy proposals could be excluded if they related to the conduct of day-to-day business. So, for example, a proposal that a utility company not build a nuclear power plant would, under the 1972 amendments, be deemed excludable as relating to the company's ordinary business operations.¹³²

This changed in 1976, however, when the SEC expressly narrowed the ordinary business exclusion in the case of proposals "with significant policy, economic or other implications."¹³³ The ordinary business exclusion was, the 1976 adopting release stated, henceforth only for proposals that "involve business matters that are mundane in nature and do not involve any substantial policy or other considerations."¹³⁴ A proposal such as the one relating to nuclear power would no longer be excludable.

B. Cracker Barrel *No-Action Letter*

These changes by the SEC set the stage for widespread use of Rule 14a-8 for the advancement of social policy-related proposals, and put the SEC staff in the business of deciding what is, and is not, a "substantial policy consideration." The SEC and the staff have struggled valiantly ever since to bring predictability and efficiency to this inherently subjective judgment. In the leading 1992 *Cracker Barrel* no-action letter, the SEC staff famously tried to craft a bright-line rule, at least in the area of employment-related proposals.¹³⁵ The staff noted that "the line between includable and excludable employment-related proposals based

under Rule 14a-8(i)(5). Social policy proposals are, however, difficult to exclude under this provision—the staff takes the view that where a proposal raises social policy issues, then it cannot be excluded even if it qualitatively falls below the financial threshold (operations that account for 5% of net earnings or gross sales) set forth in the current rule. The SEC staff's approach in this regard is consistent with the decision of the D.C. District Court in *Lovenheim v. Iroquois Brands, Ltd.*, 618 F. Supp. 554 (D.D.C. 1985) (holding that a proposal that raises social policy concerns could be deemed "otherwise significantly related" to the company's business despite not meeting the 5% test). In *Lovenheim*, however, the court noted in dicta that a company would be able to exclude a proposal that "was ethically significant in the abstract but had no meaningful relationship to the business" of the company. *Id.* at 561 n.16.

132. This example was provided by the SEC in its 1976 release that modified the approach. See Adoption of Amendments Relating to Proposals by Security Holders, *supra* note 130.

133. *Id.* at 52,998.

134. *Id.*

135. See Cracker Barrel Old Country Store, Inc., SEC No-Action Letter, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,418 (Oct. 13, 1992).

on social policy considerations has become increasingly difficult to draw. The distinctions recognized by the staff are characterized by many as tenuous, without substance and effectively nullifying the application of the ordinary business exclusion to employment-related proposals."¹³⁶ The staff stated that henceforth "the fact that a shareholder proposal concerning a company's employment policies and practices for the general workforce is tied to a social issue will no longer be viewed as removing the proposal from the realm of ordinary business operations of the registrant."¹³⁷ Instead, any employment-related proposal would be excludable, other than those relating to senior executives, which would still be seen as "inherently outside the scope of normal or routine practices in the running of the company's operations."¹³⁸

Not surprisingly, this change in approach was met with controversy and litigation. Shareholder groups argued that it unfairly broadened the ordinary business exclusion, while corporate advocates argued that the uncertainty and line-drawing was not limited to the employment-related context and therefore a similar bright-line test should apply in other contexts. The proponent in the *Cracker Barrel* case sued the SEC, challenging the validity of making such an interpretive change through a no-action letter. The district court ruled against the SEC, but this decision was reversed by the Second Circuit Court of Appeals on the basis that no-action letters were interpretive acts, not legislative acts, and therefore did not require notice and comment under the Administrative Procedures Act.¹³⁹

Thus, the *Cracker Barrel* approach stood, and for a period of time social policy proposals were subject to a bifurcated approach, with employment-related proposals (for example, those relating to discrimination in hiring) generally excludable notwithstanding a social policy nexus, but proposals in other areas continuing to require the staff to decide what is and is not a substantial policy consideration. In 1996, the year after the resolution of the *Cracker Barrel* litigation, the U.S. Congress weighed in on the question by requiring the SEC to conduct a study of "the ability of shareholders to have proposals relating to corporate practices and social issues included as part of proxy statements."¹⁴⁰ The legislative history behind this statutory mandate

136. *Id.*

137. *Id.*

138. *Id.*

139. *See* N.Y.C. Emp. Ret. Sys. v. SEC, 45 F.3d 7, 14 (2d Cir. 1995).

140. *See* National Securities Markets Improvement Act of 1996, Pub. L. 104-290, 110 Stat. 3416, 3450 § 510(b)(1)(B) (1996).

makes clear that it was a direct response to the “enormous controversy” generated by the *Cracker Barrel* decision.¹⁴¹

C. *The 1998 Rule Changes and a New Approach*

The SEC’s review culminated in its 1998 release that rescinded the *Cracker Barrel* approach and laid out a new, and the current, paradigm for assessment of social policy proposals. This release marks a return to the “case-by-case analytical approach,” which the SEC acknowledged will require the staff to make “reasoned distinctions” that in some cases may be “somewhat tenuous.”¹⁴² The SEC sought to give guidance on the “ordinary business” approach going forward by highlighting the two central considerations to its analysis:

- If the proposal relates to tasks so fundamental to management’s ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight, then it will be excludable *unless it raises significant policy issues that transcend day-to-day business matters.*¹⁴³
- If the proposal seeks to “micro-manage” the company by probing too deeply into matters of a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgment, then it will be excludable.¹⁴⁴

Over the years, the SEC staff has looked at a variety of factors as to whether a policy issue raised by a proposal is “significant” for these purposes, but the key question is whether it is a subject of “widespread public debate,” as manifested by media coverage, legislative or regulatory focus, or other public discourse.¹⁴⁵

The application of this standard is, by its nature, subjective, and, despite the best efforts of the SEC staff, the outcome of this process remains extremely difficult to predict. The lack of consistency over time is not an indication of inadequate analysis by the SEC staff—the SEC’s 1998 release expressly contemplated that the same proposal might be treated differently at different

141. See S. REP. NO. 104-293, at 19–20.

142. See Amendments to Rules of Shareholder Proposals, Exchange Act Release No. 40018, Investment Company Act Release No. 23200, 63 Fed. Reg. 29,106 (May 28, 1998).

143. *Id.*

144. *Id.*

145. *Id.*

times, depending on the level of public debate on the topic.¹⁴⁶ The variety of topics that have, or have not, been deemed to raise significant policy issues, and the difficulty of reconciling certain specific decisions, have been well documented and discussed.¹⁴⁷ Suffice it to say that the process continues to create unpredictability for shareholders and corporations, and is a significant consumer of the time, effort, and other resources of the SEC staff, shareholders, and issuers.

D. *Recent Refinements*

In recent years, the SEC staff has made a number of refinements to its analysis of social policy proposals that have made it even more difficult for companies to exclude certain of these proposals. In 2009, the SEC staff issued Staff Legal Bulletin No. 14E, which announced a change in approach for proposals relating to the risks to the company from a social policy issue.¹⁴⁸ The staff's previous stance had been that a proposal could be excluded even if it related to a significant social policy if the focus of the proposal was on the company's internal assessment and management of the risks and liabilities presented by the issue, rather than the broader social effects of the company's operations.¹⁴⁹ The new approach does not permit exclusion if the risk at issue arises from a significant policy matter, regardless of whether the proposal focuses on the resulting risk to the company or the broader social impact.

During the 2010 proxy season, the staff applied this approach to situations such as those contemplated in Staff Legal Bulletin No. 14E—proposals that relate to the company's "assessment of the risks and liabilities that the company faces *as a result of its operations*."¹⁵⁰ So, in a number of 2010 letters, the SEC staff's basis for not permitting exclusion of environment-related risk proposals was that the particular proposal (to quote the staff's response letters) "focuses primarily on the environmental

146. *Id.* ("From time to time, in light of experience dealing with proposals in specific subject areas, and reflecting changing societal views, the Division adjusts its view with respect to 'social policy' proposals involving ordinary business.").

147. *See, e.g.*, MARK A. SARGENT & DENNIS R. HONABACH, PROXY RULES HANDBOOK § 5.45 (2010) (discussing a number of examples of no-action letters that illustrate the unpredictable nature of the ordinary business exclusion).

148. *See* SEC Staff Legal Bulletin No. 14E, *supra* note 1.

149. *See* SEC Staff Legal Bulletin No. 14C, 2005 WL 6283646 (June 28, 2005).

150. SEC Staff Legal Bulletin No. 14E, *supra* note 1.

impacts of [the company's] operations."¹⁵¹ Conversely, the staff permitted exclusion of environment-related proposals where the relevant proposal (again, in the words of the staff) "addresses matters beyond the environmental impact of [the company's] decisions."¹⁵²

In 2011, the staff expanded this approach to risks that do not arise from the company's operations, but that may nevertheless impact the company. This came up in the context of climate change—a conservative shareholder group submitted proposals to a number of groups that called into question the quality, integrity and accuracy of global warming science, and that asked for a report on the business risk to the company relating to climate change developments. The proposal did not imply that the companies' operations had any impact on global warming. Nevertheless, the staff did not permit exclusion of the proposals, and used newly expanded language to note that the proposals "focuse[d] on the significant policy issue of climate change."¹⁵³

This expanded approach may seem innocuous in this particular instance, but if applied broadly it has the potential to broaden significantly the availability of Rule 14a-8 as a mechanism to raise broad policy questions. Arguably, any company that may be impacted by global warming or related developments (i.e., virtually any company) would be required to include such a proposal.¹⁵⁴ Likewise, one could imagine any number of issues that are the subject of widespread public debate and that present risks that all companies must deal with—for example, healthcare costs, information security, terrorism, pandemics, government fiscal policy, etc. The staff's current approach raises the question of what the limiting factor is, if any. If shareholders are

151. See, e.g., Chesapeake Energy Corp., SEC No-Action Letter, 2010 WL 673784 (Apr. 13, 2010); Ultra Petroleum Corp., SEC No-Action Letter, 2010 WL 620062 (Mar. 26, 2010); EOG Resources, Inc., SEC No-Action Letter, 2010 WL 4922493 (Feb. 3, 2010); Cabot Oil & Gas Corp., SEC No-Action Letter, 2010 WL 4922501 (Jan. 28, 2010); PPG Industries, Inc., SEC No-Action Letter, 2010 WL 4922433 (Jan. 15, 2010).

152. See, e.g., JPMorgan Chase & Co., SEC No-Action Letter, 2010 WL 147293 (Mar. 12, 2010); Bank of America Corp., SEC No-Action Letter, 2010 WL 4922465 (Feb. 24, 2010).

153. See Wal-Mart Stores, Inc., SEC No-Action Letter, 2011 WL 304197 (Mar. 28, 2011), General Electric Co., SEC No-Action Letter, 2010 WL 5124311 (Feb. 8, 2011), The Goldman Sachs Group, Inc., SEC No-Action Letter, 2010 WL 5196317 (Feb. 7, 2011).

154. A company could seek to exclude the proposal under Rule 14a-8(i)(5) as not significantly related to the company's business. However, for a truly general social issue with broad implications, such as climate change, it may be difficult for any company to argue that there is no meaningful relationship to the company's business. See *supra* note 130.

permitted to use issuer proxy statements as a forum for general social policy discussions, this brings us full circle, and creates precisely the situation that the SEC wanted to avoid in its initial 1945 statement on social policy proposals.¹⁵⁵

IV. INCREASED IMPACT OF SOCIAL POLICY PROPOSALS

A. *Increased Frequency and Support of Social Policy Proposals*

Until recently, social policy proposals received a relatively low level of shareholder support. They thus served more as a medium for one shareholder to express views to the board, to other shareholders, and to the public at large, rather than as a mechanism for corporate change. In the last two years, however, social policy proposals have become increasingly prevalent and received increasing levels of shareholder support. A survey published in the Manhattan Institute's Proxy Monitor indicated that 51% of 2011 shareholder proposals at Fortune 100 companies related to social policy issues,¹⁵⁶ up from 38% for the period 2008–2010, with the absolute number of social policy proposals increasing 16% from 2010 levels.¹⁵⁷ The Proxy Monitor study indicated that 14% of social policy proposals received support of at least 30% of shareholders, compared to only 7% in 2008. According to Institutional Shareholder Services, the average level of shareholder support for social policy proposals was over 20% during the 2011 proxy season, up from 8.7% a decade ago.¹⁵⁸

Indeed, although the level of shareholder support for social policy proposals is generally well below that for corporate governance proposals, there is an increasing possibility that social policy proposals will be approved by a majority of votes cast.¹⁵⁹ Prior to

155. See Exchange Act Release No. 3638, Investment Company Act Release No. 735, 1945 WL 27415 (Jan. 3, 1945).

156. See *2011 Proxy Season Review, Database Reveals Decline in Successful Shareholder Proposals*, PROXY MONITOR (2011), <http://www.proxymonitor.org/Forms/Finding7.aspx>. For purposes of statistics given in this Article, "social policy proposals" are those relating to matters other than executive compensation or governance structure. *Id.*

157. See *New Database Reveals Shareholder Proposal Trends*, PROXY MONITOR (Winter 2011), <http://www.proxymonitor.org/pdf/Finding7.pdf>.

158. See *2011 U.S. Season Review: E&S Proposals*, INSTITUTIONAL SHAREHOLDER SERVS., <http://www.issgovernance.com/docs/ESProposals> (last visited Dec. 13, 2011).

159. Receipt of a majority of votes cast is a common focus of investor groups assessing the outcome of shareholder proposals, though in many cases it does not necessarily mean the proposal has formally "passed," as a state law matter. The required threshold for shareholder action under a corporation's governing documents or state law is often a higher threshold—for example, majority of shares present in person or by proxy at the meeting and entitled to

2011, a very small number of social policy proposals received majority approval—no more than one or two a year, typically at smaller companies.¹⁶⁰ In 2011, social policy proposals received the approval of a majority of votes cast at four companies that we are aware of, all of which were Fortune 500 companies. These four proposals covered a range of topics: sexual orientation anti-discrimination policies,¹⁶¹ handling of coal combustion waste,¹⁶² political contributions,¹⁶³ and facility safety management.¹⁶⁴

B. *Practical Impact on Directors*

Since the SEC first commented on the issue in 1945, the inclusion of social policy proposals has generally been framed as a question of cost and resource allocation: under what circumstances is the company's proxy statement the appropriate forum for these issues, and to what extent is the mechanism an appropriate use of SEC, company, and shareholder resources? Now, however, the increasing focus on social policy proposals, and the apparently increasing likelihood that they will pass, raises the question to a different, and more fundamental, level: how do

vote (i.e., including abstentions), or the majority of shares outstanding. Even most of the proposals that received a majority of votes cast did not in fact "pass" as a state corporate law matter.

160. In each of 2004, 2005, 2006, and 2010, we are aware of only one social policy proposal per year receiving approval of a majority of votes cast. In each of 2007, 2008, and 2009, we are aware of only two such proposals per year receiving approval of a majority of votes cast. Of these ten proposals, six advocated the adoption of sexual orientation anti-discrimination policies, two requested reports on political contributions, and two were related to environmental or sustainability issues.

161. See KBR, Proxy Statement (Form 14-A) (Apr. 4, 2011). This proposal received approval of 62% of votes cast, 55% of votes present and entitled to vote, and 45% of shares outstanding. The proposal passed under the company's applicable voting standard. See KBR, Current Report (Form 8-K) (May 19, 2011).

162. See Ameren Corp., Proxy Statement (Form 14-A) (Mar. 9, 2011). This proposal received approval of 53% of votes cast, 47% of votes present and entitled to vote, and 31% of shares outstanding. The proposal did not pass under the company's applicable voting standard. See Ameren Corp., Current Report (Form 8-K) (Apr. 21, 2011).

163. See Sprint Nextel Corp., Proxy Statement (Form 14-A) (Mar. 28, 2011). This proposal received approval of 53% of votes cast, 41% of votes present and entitled to vote, and 31% of shares outstanding. The proposal did not pass under the company's applicable voting standard. See Sprint Nextel Corp., Current Report (Form 8-K) (May 10, 2011).

164. See Tesoro Corp., Proxy Statement (Form 14-A) (Mar. 24, 2011). This proposal received approval of 54% of votes cast, 34% of votes present and entitled to vote, and 23% of shares outstanding. The proposal did not pass under the company's applicable voting standard. See Tesoro Corp., Current Report (Form 8-K) (May 4, 2011).

these proposals fit into the balance of authority established among the board, management, and shareholders?

In particular, does the ability of shareholders to advance and pass social policy resolutions undermine the centrality and autonomy of the board of directors, which has been the thrust of governance developments in recent decades? Because social policy proposals are inevitably precatory in nature—that is, they do not on their face compel the board to take any particular action, but merely request that action be taken¹⁶⁵—one could argue that they do not impact the balance of power at all. As a legal matter, directors continue to be free to exercise their judgment as to whether and how to address the shareholder request. In this way, regardless of the voting threshold, the shareholder proposal system functions merely as a method by which shareholders can communicate with the board and each other.

As a practical matter, however, the ramifications of a successful proposal can be of much greater import. One critical component to understanding the practical impact involves the policies of the major proxy advisory firms—particularly Institutional Shareholder Services (“ISS”)—and their interplay with majority voting provisions. ISS is a highly influential firm that provides analyses of matters coming to a shareholder vote—both in the takeover context and in the annual meeting context. The services provided by ISS and other proxy advisory firms include advising their shareholder clients (including many large investors) as to a recommended vote on particular proposals.¹⁶⁶

One of ISS’s policies is to recommend that shareholders vote “against” or “withhold” for the election of *every director* (other than new nominees) if ISS determines that the board has “failed to act” on a shareholder proposal that received approval of a majority of shares outstanding in the prior year, or that received approval of a majority of votes cast in the prior year and one of the two preceding years.¹⁶⁷ ISS’s rationale for this

165. The precatory nature of shareholder proposals is due to the SEC’s interpretation of the exclusion under Rule 14a-8(i)(1) for proposals that are “improper under state law.” The SEC has accepted the view expressed by counsel in corporate no-action requests that a proposal that purports to bind the board of directors would be contrary to state law, in that it would deprive the board of its ability to exercise independent judgment as required by its fiduciary duties. But if a proposal is in the form of a non-binding request, then the SEC takes the view that it is not contrary to state law. See 17 C.F.R. § 240.14a-8(i)(2) (2011) (note).

166. A large number of institutional investors almost always vote in accordance with ISS’s recommendations.

167. ISS would also recommend “against” or “withhold” if the board fails to take action on two different proposals that received approval of a majority of

approach is that the “inaction demonstrates a lack of board responsiveness” and a failure of boards to include “company owners in the governance process.”¹⁶⁸

Thus, the board of a company whose shareholders approve a social policy proposal that the directors do not support are placed in a potentially conflicted position.¹⁶⁹ It is clear, as a state law matter, that the directors have a responsibility to act in the best interest of the corporation and its shareholders, as they see it. Under state law, this clearly does not mean that they are, to use the words of a Delaware court, “obligated to follow the wishes of a majority of shares,” and in fact state law prevents directors from abdicating their responsibilities and merely delegating decisions to shareholders.¹⁷⁰ Nonetheless, the directors are, to some extent, subject to a personal conflict: if they act in accordance with their best judgment, as state law requires them to do, and do not implement a precatory proposal, then they know that they (and the rest of the board) may be subject to a withhold vote recommendation from the proxy advisory firms. A director’s personal interest in retaining the directorship position, and the director’s concern over the potential destabilizing effect on the company if the entire board is subject to withhold vote recommendations, may conflict with his or her obligations as a director.

The threat of a withhold vote recommendation against a director is by no means an empty gesture, given the cumulative effect of recent regulatory and governance developments. The growth of majority voting over the past several years has led to a situation where, even though an election is uncontested so the director cannot nominally “lose,” receiving a sufficient number of “withhold” or “no” votes can require a director to submit a resignation under company policies.¹⁷¹ The elimination of broker discretionary voting in director elections, beginning in 2009,

votes cast in successive years. See U.S. Proxy Voting Manual, INSTITUTIONAL S’HOLDER SERVS., <http://governanceanalytics.com/content/menutop/content/subscription/usvmfiles/board-of-directors.html> (last visited Dec. 13, 2011).

168. *Id.*

169. This is an issue, of course, with respect to any shareholder proposal, not just social policy proposals. Social policy proposals, however, present the greatest risk of a conflict, because they generally relate directly to the board’s oversight of the company’s business operations and the impact of their implementation would generally be complex and unpredictable.

170. *Paramount Commc’ns Inc. v. Time Inc.*, No. 10866., 1989 WL 79880, at *30 (Del. Ch. July 14, 1989); see also *Paramount Commc’ns Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1989); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

171. See *supra* Section II.C.4 for a discussion of majority voting policies.

has removed many retail votes from the voting pool, and has been seen by many to increase the potential power of a withhold vote recommendation by the proxy advisory firms.¹⁷² Finally, as described further in Section II.C.4, pursuant to revisions to Rule 14a-8(i)(8) that took effect in September 2011, shareholders may now propose that a company adopt its own proxy access bylaws, whereby shareholders may include nominees in the company proxy materials. Although it is too early to tell whether the adoption of proxy access bylaws will become a widespread corporate governance practice, the advent of proxy access has the potential to increase the number of contested elections, and thus to increase the impact on incumbent directors of an adverse recommendation from ISS.

The mere fact that shareholders may not support a director who has managed the company in a manner the shareholders do not like should not be a worrisome conflict: that is exactly what the exercise by shareholders of their voting rights for directors entails. What is of concern is how the combination of SEC policy, special interest activism, and the concentration of influence in proxy advisory firms have combined to make this a more formulaic and non-deliberative process that can impair the board's deliberation on complex social issues. If a director, or the entire board, gets voted out after the board failed to implement a shareholder proposal, this is not necessarily reflective of the collective view of all of the corporation's shareholders, or in the collective interest of the corporation, its shareholders, and its other stakeholders. The result has likely been affected, perhaps decisively, by the outside influence and largely unregulated and potentially opaque decisions of a relatively small number of players (e.g., a special interest proponent, the major proxy advisory firms, and

172. In July 2009, the SEC approved, by a 3-2 vote, a proposal by the NYSE to eliminate broker discretionary voting on the election of directors. *See* Order Approving Proposer Rule Change to Eliminate Broker Discretionary Voting for the Election of Voters, Exchange Act Release No. 60215, 74 Fed. Reg. 33,293 (July 10, 2009). This rule change added "the election of directors" to the list of matters on which NYSE member organizations are not permitted to give a proxy to vote without instructions from the beneficial owner. The discussion between the SEC Commissioners and the SEC staff at the open meeting approving the rule change raised the concern that the rule change could increase the influence of special interest groups and shareholder activists relative to retail investors, and have a particular impact on companies with majority voting provisions. Section 957 of the Dodd-Frank Act codifies the NYSE's approach to broker voting by amending section 6(b) of the Exchange Act. Pub. L. No. 111-203, 124 Stat. 1376, 1906-07 (2010) (codified as amended at 15 U.S.C. § 78f (2010)).

those institutional investors who follow these firms' recommendations virtually automatically).

C. *Analysis of Governance Proposals vs. Social Policy Proposals*

These withhold vote recommendations have, in the past, occurred primarily in the wake of governance-related proposals (such as adoption of majority voting, elimination of classified boards, or elimination of poison pills), because these are the proposals that have seen strong shareholder support in the past.¹⁷³ In fact, ISS's stated rationale for its policies on "board responsiveness" focuses on governance-related proposals (though the policies, on their face, apply more broadly).¹⁷⁴

The leverage provided to shareholders, and the personal conflict for directors, is arguably less problematic in the context of governance-related provisions. Provisions such as majority voting, classified boards, and supermajority voting thresholds relate specifically to the allocation of power between shareholders and the board, and are traditionally governed by the certificate of incorporation and bylaws—documents over which state law expressly gives shareholders some level of control. Poison pills relate to takeover defenses, and thus are generally connected to a subject matter (e.g., mergers) over which shareholders traditionally also have some control under state law. Direct shareholder influence over these matters does undercut the role of the nominating and corporate governance committee (which was a significant focus of post-Enron stock exchange and SEC disclosure rules) and undermines the integrity of that committee's independent judgment, but these are arguably areas on which state law contemplates shareholders acting directly. In addition, because these proposals address the balance of power between directors and shareholders, there is some logic to giving both of those parties a voice in the resolution of the matter.

In contrast, social policy proposals fall squarely within the management of the business and affairs of the corporation—an area that state law places upon the board. In addition, social policy proposals (unlike governance proposals) do not relate to the extent of board power, and so there is no reason to conclude

173. See Diane Del Guercio, Laura Seery & Tracie Woitke, *Do Boards Pay Attention when Institutional Investor Activists "Just Vote No"?*, 90 J. FIN. ECON. 84 (2008) (analyzing "withhold vote" campaigns from 1990–2003).

174. U.S. Proxy Voting Manual, *supra* note 167 ("It is therefore important for shareholders to assess the degree to which directors have included or excluded company owners in the governance process, specifically in terms of adopting charter and bylaw amendments that contribute to either an open or closed corporate governance structure.").

that the board cannot serve as an independent decision-maker on these matters. There is no compelling reason to treat social policy issues differently in this regard than other matters relating to the board's oversight of the company's business, such as whether to enter into a particular line of business, whether to unionize, or other key business decisions.

This distinction between business functions (which are the responsibility of the board) and governance structural matters (which are appropriate matters for shareholder influence) was analyzed by the Delaware Supreme Court in the *CA, Inc.* case in 2008.¹⁷⁵ In this case, the court sought to reconcile two provisions of the DGCL: the right of shareholders to amend the bylaws and the role of the board to manage the business and affairs of the corporation. In interpreting these two sections of the DGCL, the Delaware Supreme Court stated that "a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions."¹⁷⁶ Thus, "the shareholders' statutory power to adopt, amend or repeal bylaws is not coextensive with the board's concurrent power and is limited by the board's management prerogatives under Section 141(a)."¹⁷⁷ The court noted that "stockholders of a corporation subject to the DGCL may not directly manage the business and affairs of the corporation, at least without specific authorization in either the statute or the certificate of incorporation."¹⁷⁸

The distinction made by the *CA, Inc.* case between "procedural" or "process-oriented" matters, on the one hand, and managerial or business matters, on the other, is consistent with the general governance paradigm discussed above, and has generally been supported by the SEC's approach to Rule 14a-8 proposals. The SEC's treatment of social policy proposals as somehow beyond the corporation's "management functions," however, runs counter to this structure. It seems clear that the social policy considerations that underlie a corporation's business deci-

175. *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227 (Del. 2008). This case involved a Rule 14a-8 proposal seeking to amend the company's bylaws to direct the board to reimburse certain stockholders for proxy-related expenses. The SEC referred to the Delaware Supreme Court the questions of whether this was a proper subject for action by shareholders under state law, and whether the proposal, if adopted, would cause the corporation to violate Delaware law. The court held that the proposal was a proper subject for shareholder action because it was "procedural" in nature, but that its adoption would violate state law by restricting the board's exercise of its fiduciary duties. *Id.* at 240.

176. *Id.* at 234–35.

177. *Id.* at 232.

178. *Id.*

sions go beyond the procedural, process-oriented matters that normally are, or should be, proper subjects for direct shareholder control.

It is telling that the “social policy” carve-out to the ordinary business exclusion first arose in 1976, at the same time as the governance community was turning its focus to the appropriate role of the board of directors.¹⁷⁹ The general problem being addressed was the same: a sense that management was not sufficiently accountable to shareholders. The dominant approach to solving this problem was through increasing the autonomy, independence, and involvement of the board of directors, together with expanding disclosure and providing means for shareholders to communicate with the board, all as described in Part II. These mechanisms for addressing the issue are all supportive of each other, in that they reduce conflicts of interests and allow the respective constituents—the board, management, and shareholders—to act in their respective roles in a more informed and productive manner.

In contrast, the expanded ability of shareholders to advance social policy proposals, and the resulting pressure this places on directors, are at odds with this model. The SEC’s analysis of social policy proposals has remained rooted in the concept of shareholder primacy versus management primacy, without appropriately taking consideration of the rise of the board as an independent monitor of management and representative of shareholders. The language in the SEC’s and staff’s statements on the ordinary business exclusion seem to reflect a traditional ownership approach, where management runs the day-to-day operations of the business on behalf of shareholders, who have ultimate control and oversight. For example, the SEC’s 1998 release says that the term “ordinary business” is intended to provide “management with flexibility in directing certain core matters involving the company’s business and operations.” The 1998 release goes on to say that “[c]ertain tasks are so fundamental to management’s ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight.”¹⁸⁰ This formulation, however, leaves no room for the board of directors. Naturally, the board does not manage the ordinary, day-to-day business of the company, but rather acts

179. See Adoption of Amendments Relating to Proposals by Security Holders, *supra* note 110. Of course, the focus on the role of directors was primarily an outgrowth of the various corporate scandals of the late 1960s and early 1970s, while the focus on shareholder proposals also reflected the backdrop of civil rights, environmental, consumer safety and anti-war movements.

180. See Amendments to Rules of Shareholder Proposals, *supra* note 142.

to oversee management's operation of the company and to oversee the kind of complex, balanced policy decisions that social policy proposals seek to address.¹⁸¹ The 1998 release states that shareholders should not "micro-manage" the company, but that formulation implies that they are supposed to "manage" the company at a higher level, which clearly is not the case under state law and under the dominant governance model for public companies—it is the board, not shareholders, that oversees the management of the corporation.

Outside the social proposal context, the SEC recognizes that the directors, not the shareholders, have the ultimate authority as to the oversight of the company's business. This is reflected in the ability of companies to exclude proposals that are mandatory rather than precatory, and that would purport to bind the board to the wishes of the voting shareholders. The combination, however, of the SEC's expansive approach to social policy proposals, the increase in shareholder activism and the practices of influential proxy advisory firms, is increasingly at odds with this approach and threatens to create conflicts that undermine the independence and objectivity of the board's decision-making with respect to those proposals.

We believe this distinction is critical enough that the SEC should consider modifying its interpretive position on Rule 14a-8 to allow the exclusion of social policy proposals as relating to the company's ordinary business operations. We believe it would be consistent with the dominant director-centric governance model to interpret the term "ordinary business operations" to include not only those operating matters that management typically deals with, but also the higher level decision-making that is typically entrusted to the board, including complex social policy-related determinations. This would allow the focus of shareholder proposals to remain on governance-related matters, and would be consistent with the SEC's historical view that the company's proxy statement is not an appropriate forum for debate on general political, social, or economic matters.¹⁸²

181. See, e.g., Statement of the Business Roundtable, *supra* note 13, at 2094 ("The role of the board cannot be considered except in the context of the indispensable role played by operating management in the conduct of day-to-day corporate affairs. It is plainly impossible for a board composed partly of 'outsiders', that is partly of persons who are not full-time employees, to conduct such day-to-day affairs.").

182. See Exchange Act Release No. 3638, *supra* note 127.

V. SHAREHOLDER DEMOCRACY

The argument in favor of a broad application of Rule 14a-8 is frequently presented in terms of “shareholder democracy.”¹⁸³ Overriding the considerations discussed above, could the ability of shareholders to raise social policy proposals advance a more fundamental principle of democracy? There is something instinctively appealing about the picture of individual shareholders rising up to urge a faceless corporation to elevate moral principles over pure profit-seeking. The actual situation is, of course, considerably more complex. This Part will examine the concept of “shareholder democracy” to assess whether general democratic principles provide a basis for direct shareholder governance, and whether the now-accepted paradigm of a strong and independent board of directors, expansive disclosure requirements, shareholder communication channels, and protection of the shareholder voting franchise is at odds with democratic principles.

A. *What is Meant by “Shareholder Democracy”?*

“Shareholder democracy” can mean one of several concepts.¹⁸⁴ At one level, it can simply mean the exercise by shareholders of their voting franchise as provided by state corporate law.¹⁸⁵ More broadly, it can be viewed metaphorically, with the corporation seen as analogous to a nation-state, with management as the governmental bureaucracy, the board as elected representatives, and shareholders as those citizens who are given voting rights.¹⁸⁶ Or it can be taken literally, as a statement that shareholder voting rights are a necessary element of a democratic society, given the importance of corporate actors to the

183. See, e.g., Frank D. Emerson & Franklin D. Latcham, *The SEC Proxy Proposal Rule: The Corporate Gadget*, 19 U. CHI. L. REV. 807 (1952); Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97 (1988); Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholder Democracy*, 63 WASH. & LEE L. REV. 1503 (2006); Marilyn B. Cane & Stacey L. Silva, *Shareholder Democracy and the SEC's Proxy Rules: In the Boardroom*, 15 FORDHAM J. CORP. & FIN. L. 241 (2009).

184. See Ryan, *supra* note 183, at 102.

185. See, e.g., Colleen A. Dunlavy, *Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights*, 63 WASH. & LEE L. REV. 1347 (2006) (discussing the use of “shareholder democracy” in the context of vertical power relations between shareholders and management).

186. See, e.g., Usha Rodrigues, *The Seductive Comparison of Shareholder and Civic Democracy*, 63 WASH. & LEE L. REV. 1389 (2006).

business of the nation.¹⁸⁷ Finally, a reference to “shareholder democracy” may mean some unspecified combination of these concepts.

A further complication in the analysis is that there are multiple concepts of “democracy.” As discussed below, there are both direct and representative democracies and numerous variants on each. Shareholder decision-making on an issue would be a form of direct democracy while the determination by a strong and independent board reflects a representative democracy.

B. *Direct Democracy vs. Representative Democracy in the Political Context*

1. Greece and Rome

Direct lawmaking by the voting citizenry was a feature of the very earliest democracies. The ancient Greek city-states featured a variety of forms of direct citizen participation. In Athens, lawmaking was conducted by an assembly consisting of all adult citizens—generally, males that had completed military training—acting by a simple majority. At its peak, this public assembly constituted tens of thousands of people. In Sparta, laws were subject to approval by a popular vote.¹⁸⁸ Plato, as an immediate observer of this form of government in action, famously described democracy (by which he meant direct democracy) as an “agreeable anarchic form of society” that, while it embodies freedom, does not advance higher values.¹⁸⁹ In *The Republic*, Plato places direct democracy above only tyranny, and far below rule by aristocratic “philosopher-kings,” in his ranking of the various forms of government.

Direct democracy was an early component of the Roman Republic, with legislation originating in public assemblies.¹⁹⁰ Over time, however, Rome’s expansion made this form less practicable, and the Roman Republic form of government began to favor its representative elements (including elected consuls), and ultimately turned toward aristocracy and monarchy, with practical control of the government shifting to the patrician class.¹⁹¹

187. David C. Bayne, *The Basic Rationale of Proper Subject*, 34 U. DET. L.J. 575, 575 (1957) (“[T]he failure of democracy within the modern American corporation is the failure of democracy *pro tanto* in our culture.”).

188. See Robert G. Natelson, *A Republic, Not a Democracy? Initiative, Referendum, and the Constitution’s Guarantee Clause*, 80 TEX. L. REV. 807, 831 (2002).

189. PLATO, *THE REPUBLIC* 294 (Desmond Lee, trans., Penguin 2d ed., 2003) (1955).

190. See Natelson, *supra* note 188, at 832 (citing Greek historian Polybius).

191. See THE COLUMBIA ENCYCLOPEDIA 2351–52 (5th ed. 1993).

2. The Enlightenment

The “ideal” form of democracy was the subject of much philosophical discussion in Europe in the 18th century, which can be illustrated by contrasting the views of French political philosophers Jean-Jacques Rousseau and Baron de Montesquieu. Rousseau was an advocate of direct democracy, and believed that it was not sufficient for the preservation of freedom that the people establish a government and provide for the election of representatives. He rejected the concept of elected representatives as follows:

Any law which the People has not ratified in person is null; it is not a law. The English people thinks it is free; it is greatly mistaken, it is free only during the election of Members of Parliament; as soon as they are elected, it is enslaved, it is nothing. The use it makes of its freedom during the brief moments it has it fully warrants its losing it.¹⁹²

The only instance in which Rousseau would accept representative democracy is if the representatives are seen as agents of the people with no power to “conclude anything definitively”; that is, their actions are always subject to ratification or reversal by the people.¹⁹³

Rousseau’s view was a counterpoint to the political model advocated by Montesquieu. Montesquieu appreciated that political power should ultimately reside in the governed, but believed that direct democracy was not practical or advisable:

As in a free state, every man who is supposed a free agent, ought to be his own governor; so the legislative power should reside in the whole body of the people. But since this is impossible in large states, and in small ones is subject to many inconveniences, it is fit the people should act by their representatives, what they cannot act by themselves.¹⁹⁴

Montesquieu’s views on direct democracy stemmed not only from a concern for practicalities and efficiency, but from a skepticism as to the abilities of the populace to make informed decisions:

192. JEAN-JACQUES ROUSSEAU, *THE SOCIAL CONTRACT AND OTHER LATER POLITICAL WRITINGS* bk. III, ch. 15, at 114 (Victor Gourevitch ed. & trans., 1997).

193. Nelson Lund, *Rousseau and Direct Democracy*, 13 J. CONTEMP. LEGAL ISSUES 459, 493 n.101 (2004) (citing ROUSSEAU, *supra* note 192).

194. 1 BARON DE MONTESQUIEU, *THE SPIRIT OF LAWS* bk. 11, ch. 6, at 183–84 (5th ed. 1802).

One great fault there was in most of the ancient republics, that the people had a right to active resolutions, such as require some execution, a thing of which they are absolutely incapable, they ought to have no hand in the government, but for the choosing of representatives, which is within their reach.¹⁹⁵

3. The United States Representative System

In establishing a system of government based on representative democracy, the United States founding fathers were influenced heavily by Montesquieu and his peers.¹⁹⁶ A primary concern that the Founders had with direct democracy—what James Madison referred to as “pure democracy”—was the risk of factionalism. Madison described a faction as “a number of citizens, whether amounting to a majority or a minority of the whole, who are united and actuated by some common impulse of passion, or of interest, adverse to the rights of other citizens, or to the permanent and aggregate interests of the community.”¹⁹⁷ Madison saw the cure for the dangers presented by factionalism to lie in a representative form of democracy, opining that “the public voice, pronounced by the representatives of the people, will be more consonant to the public good than if pronounced by the people themselves, convened for the purpose.” Madison also noted “the greater number of citizens and extent of territory, which may be brought within the compass of republican, than of democratic government; and it is this circumstance principally which renders factious combinations less to be dreaded in the former than in the latter.”¹⁹⁸ In this way, the U.S. federal system was structured as a representative democracy rather than a direct democracy.¹⁹⁹

195. *Id.* at 184.

196. See Natelson, *supra* note 188, at 820; see also THE FEDERALIST NO. 10 (James Madison) (discussing Montesquieu’s views on representative democracy).

197. THE FEDERALIST NO. 10, at 57 (James Madison) (Jacob E. Cooke ed., 1961).

198. *Id.* at 63. Madison also sought to downplay the differences between the American form of representative government and earlier democratic governments, arguing that Athens, Sparta and Rome all used representation in various forms. See THE FEDERALIST NO. 63, at 426 (James Madison).

199. Although direct democracy does not exist at the U.S. federal level, it does to some extent exist in many state and local governments, in the form of voter referenda and initiatives. These voter referenda and initiatives, however, represent a minuscule percentage of the total legislative activity of U.S. states and municipalities. See Natelson, *supra* note 188, at 807–08 (“Of the more than seventeen thousand laws adopted in 1996 in the twenty-four states allowing citi-

C. *Shareholder Democracy vs. Representative Democracy
in the Corporate Context*

The Founders' representative government system can be analogized to the dominant paradigm for public company corporate governance. The corporation is managed by a strong board of directors, elected by the shareholders (who are many in number), just as the nation's laws are developed by elected legislators. Appeals to the principles of democracy as support for direct shareholder voting rights may have some validity when they are invoked to permit shareholders to protect their voting franchise—certainly if elections are not fair, then a system can hardly be said to live up to general democratic principles. Over the past several decades, the concept of “shareholder democracy” has frequently been used in this context, including in discussions over majority voting, proxy access, and classified boards, as well as the inclusion of shareholder proposals addressing those and similar matters.²⁰⁰

Shareholder democracy is, however, far less compelling as a justification for permitting shareholders to exercise direct control over the board's oversight decisions, including those related to social policy. The balancing of policy considerations and other interests (such as profitability, sustainability, ethics, risks, and the interests of shareholders and other stakeholders) is analogous to the types of complex decisions that, for a government, would be decided by the elected legislators (or, in some cases, the elected executive branch). There is nothing “undemocratic” about vesting these decisions in elected representatives of the shareholders rather than in the shareholders directly, and in fact that is the closest analog to the U.S. federal system of government. The wide disparity of interests among corporate shareholders, and the fact that retail shares are often not voted at all,²⁰¹ raises the potential for the factionalism that Madison and his colleagues sought to address by establishing a representative system.

There are several additional reasons why a representative democracy model is particularly appropriate for a corporation,

zen initiatives, only forty-five were enacted by voter approval. More than 99.7% were enacted solely by state legislatures.”).

200. See, e.g., Ryan, *supra* note 183 (discussing the benefits of Rule 14a-8 in advancing shareholder democracy by allowing shareholders to influence the internal governance structure of a company).

201. The limited voting of retail shares was noted by the SEC in its 2010 concept release on the U.S. proxy system. See Concept Release on the U.S. Proxy System, Exchange Act Release No. 62495, Investment Company Act Release No. 29340, 75 Fed. Reg. 42,982 (July 22, 2010).

and why direct shareholder control can cause difficulties and inequities in the social policy context. One such reason is that a corporation does not have a “one-person-one-vote” model—voting is instead based on the number of shares held. If a political analogy is to be made, this is more akin to a plutocracy, rather than a democracy.²⁰² An individual shareholder who may have his or her life savings invested in the stock will have significantly less of a voice than an institutional shareholder with a large stake that represents one of many of the institution’s investments. From a democratic standpoint, an allocation of voting power based on economic investment would be deemed unacceptable. However rational this method may be as a market-related mechanism, or for financial and governance-related matters where shareholders’ interests may be seen as proportionate to their shareholdings, it tends to undermine any argument that shareholder voting on social policy matters is an example of any sort of “democracy” in action, or that a majority vote represents the moral will of a majority of *shareholders* (rather than holders of a majority of votes cast).²⁰³

Because of this imbalance in voting power, a system of direct shareholder control over company practices disproportionately elevates the interests of large shareholders over those of smaller shareholders. There is nothing in the corporate context that would function in a manner similar to a Bill of Rights to protect the rights of the minority from the acts of the majority. The vesting of authority in a board of directors with a fiduciary obligation to protect the interests of *all* shareholders is the most appropriate model for protecting the long-term interests of the corporation and its stakeholders.

Another reason that direct shareholder control in the corporate context presents even greater difficulties than it would in the political context relates to the separation of voting power and economic impact. It is much more likely in the corporate context than in the political context that the persons voting for a social policy proposal will not be the ones who suffer any economic impact from its implementation. First of all, shareholders (unlike voters) change frequently, so the shareholders at the time of the vote will not necessarily be the shareholders at the time or times that the economic impact is felt. In addition, the modern capital markets reflect a significant separation of voting

202. See Dunlavy, *supra* note 185, at 1356.

203. The difference between the views of shareholders and the views of votes cast is further expanded by the lack of voting participation by retail shareholders. Concept Release on the U.S. Proxy System, *supra* note 201.

power from economic stake in the corporation, due to hedging transactions and similar arrangements.²⁰⁴ In the political realm, voters are much more likely to continue to be citizens of the relevant jurisdiction, and to feel the impact (whether positive or negative) of the measures they are passing. This, too, is less of a concern for governance-related proposals than it is for social policy proposals, because governance proposals generally impact the voting franchise and thus are most likely to impact the interests of the shareholders who are voting.

VI. CONCLUSION

As practitioners, it has been our experience that the empowerment of a predominantly independent board of directors is an effective mechanism for protecting shareholder interests while facilitating complex and flexible decision-making at the corporate level. The elimination of conflicts of interest that undermine independent decision-making by the board has been, and should continue to be, instrumental in the success of this model. We are concerned that the use of Rule 14a-8 for social policy proposals now threatens to undermine this model and create precisely such conflicts, as a largely unintended consequence arising from the combination of majority voting provisions and other governance changes, SEC staff interpretive positions and the concentrated influence of proxy advisory firms. Accordingly, we recommend that the SEC consider interpreting the term “ordinary business operations” in Rule 14a-8 so as to include not only day-to-day operational matters but also those business functions that are typically entrusted to the board, including complex social policy-related determinations. This would not in any way detract from the authority of shareholders to make the ultimate determinations on governance-related matters, and would be consistent with the SEC’s historical view that the company’s proxy statement is not an appropriate forum for debate on general political or social matters.

204. The separation of economic and voting interests in U.S. public companies is discussed in the Exchange Release on the U.S. Proxy System. *Id.*

