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How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors

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I. INTRODUCTION

During the 1980s, both sides of the hostile takeover controversy viewed proxy contests in terms that bordered on the mythical. Those made uneasy by the takeover phenomenon, especially management, held out proxy contests as an alternative, almost utopian mechanism through which a civilized debate about corporate strategy and structure could be held. As the Delaware Supreme Court put it, "[i]f the stockholders are displeased with the actions of their elected representatives [in

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blocking a hostile takeover], the powers of corporate democracy are at their disposal to turn the board out."[1] In contrast, those who believed that takeovers were necessary to displace inefficient management or otherwise change corporate policy dismissed the proxy contest as entirely ineffective. They argued that the costs of collective action arising from dispersed share ownership reduced to allegory the prospect that the proxy process could provide a viable means to correct management failure.[2]

With the benefit of a little hindsight, both views have turned out to be wrong. Takeover proponents' dismissal of the proxy process ignored the dramatic growth in the holdings of institutional investors, and the resulting reduction in the costs associated with collective voting action.[3] Moreover, takeover proponents' dismissal of the proxy process seemed to stem from a preference (in the case of financial economists, often a purely intellectual preference) for market-based, price-driven mechanisms over ones that created a meaningful, substantive debate over corporate policy. Indeed, financial scholars often appeared to view the institutional complexity and substantive, process-driven dynamics associated with proxy contests with unease.[4] The inefficiency of proxy contests was often assumed rather than treated as a hypothesis subject to empirical test.[5]

Similarly, management's evangelical invocation of the proxy process as an alternative to hostile takeovers ignored problems with the proxy process itself and was ultimately revealed to be a strategic smokescreen. State and federal laws impose substantial barriers to the effective use of the proxy process even when the pure collective action impediments can be overcome.[6] Significantly, once it appeared that the takeover threat arising from tender offers had subsided and that proxy

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1. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (1985); *see also* Martin Lipton, *Takeovers in the Boardroom*, 35 BUS. LAW. 101, 116 (1979) (stating "[i]f the shareholders are dissatisfied with the directors' rejection of a takeover bid, they have the right, through the normal proxy machinery, to replace the directors or to instruct directors to accept a takeover bid").

2. *See, e.g.*, Frank H. Easterbrook & Daniel A. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1171 (1981) (stating "[t]he cry of 'turn the rascals out' also is not of much use, because other shareholders still find it in their self-interest to be passive . . . . Each shareholder will recognize that his votes will not effect the outcome unless he has a large block of shares"). Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 843 (1981) (stating that "[c]orporate law and economics combine to make the proxy fight an unattractive displacement mechanism").

3. INSTITUTIONAL INVESTOR PROJECT, COLUM. L. SCH., INSTITUTIONAL INVESTORS AND CAPITAL MARKETS: 1991 UPDATE (Sept. 1991) (reporting that as of 1990 institutional investors owned approximately 53% of outstanding U.S. equities and 54.8% of the outstanding stock of Business Week's 100 largest corporations ranked by stock market value).

4. *See, e.g.*, Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); Andrei Schleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986).

5. A few studies make a serious attempt to examine the efficiency of proxy contests. Notable is Harry DeAngelo & Linda DeAngelo, *Managerial Competition, Information Costs and the Governance of Publicly Held Corporations*, 23 J. FIN. 29 (1989).

6. *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 530-45 (1990) (providing a detailed account of the regulatory barriers to shareholders using the proxy mechanism).

contests might be more than myth, the same management groups that had proffered proxy contests as responsible alternatives to takeovers began erecting barriers to them. As introduced, the new Pennsylvania antitakeover statute explicitly discouraged proxy contests as well as hostile tender offers.[7] The management of Time, Inc., not satisfied with preventing its shareholders from having the opportunity to decide whether its long-term business strategy was worth more than $200 a share, crafted the convertible securities issued in connection with the Warner acquisition so that the equity of common stockholders would be substantially diluted if they had the temerity to replace as few as five of Time-Warner's twenty-seven directors without management's permission.[8] More recently, when the Securities and Exchange Commission proposed a number of quite moderate revisions in the proxy rules that would allow disinterested institutional shareholders to discuss management or third-party proxy proposals without first filing with the SEC,[9] business interests converged on Washington to urge the Secretary of Treasury and Vice-President to rein in the SEC.[10]

In all events, recent history has demythologized proxy contests. There is a growing recognition that proxy contests are important not because they are the same as hostile takeovers, a position that animated much of the original reaction to the resurgence of proxy contests, *but because they are different*. The idea is that the choice of a particular technique by which management's control of the levers of corporate governance is challenged—friendly acquisition, hostile takeover, or proxy contest—is endogenous. That is, the choice of technique is a function of the goal sought to be accomplished.[11] The proxy process is different because it can be used to effect a wide variety of incremental goals in corporate governance without the massive ownership change inherent in a hostile takeover. To be sure, outsiders can use proxy contests to displace management; in the mid-1980s many large proxy contests were undertaken in conjunction with hostile tender offers that had been frustrated through defensive activities by target management. But in a world of concentrated institutional share ownership, more narrowly focused proxy initiatives can be undertaken to pursue a wide variety of less high-stakes (for either side) activities. Through proxy initiatives, shareholders can attempt to reverse specific corporate policies, change payout levels, replace specific directors or managers, or propose alternative long-range strategies for the firm—all efforts that typically would not require the cost of the change in ownership inherent in a hostile takeover.

The diversity of strategies that can be pursued through the proxy process

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7. 15 PA. CONS. STAT. ANN. § 275 (1991); Stephen M. Bainbridge, Redirecting State Takeover Laws at Proxy Contests (Sept. 1991) (unpublished manuscript).

8. *See* Joseph A. Grundfest, *The Catch 22 in Time*, 6 MERGERS & ACQUISITIONS & CORP. GOVERNANCE L. REP. 1 (1991).

9. Regulation of Securityholder Communications, Exchange Act Release No. 29,315, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,811 (June 17, 1991).

10. *See* Stephen Labaton, *U.S. Pressed by Business Over S.E.C.*, N.Y. TIMES, Oct. 18, 1991, at D1.

11. *See* Ronald J. Gilson, The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment (Oct. 1991) (John M. Olin Program in Law and Economics, working paper No. 84).

makes it the natural focus for shareholder initiatives in an institutional environment characterized by concentrated ownership, and in an economic environment characterized by broad questions of long-run competitiveness. Hostile takeovers, whatever their merits, are expensive and all or-nothing in their ability to effect corporate change. Moreover, we seem to be entering an era where the major concern is not the deconglomerating of businesses through quick asset sales that characterized the 1980s,[12] but rather effecting the resurgence of American industry necessary to respond to global competitiveness. In this era the need is not so much for the episodic and confrontational monitoring of the takeover market, but rather for the continuous and textured monitoring said to characterize the German and Japanese corporate governance systems.[13] In the United States the proxy process may be the mechanism of choice, precisely because it lends itself to incremental strategies and to substantive debates over the future direction of corporate policy.

Expert minority board representation is one method by which institutional investors and other large shareholders can institutionalize the constructive engagement suited to the problems of the 1990s. In contrast to traditional outside directors, expert directors proffered by large shareholders should have the time and incentives to provide ongoing monitoring.[14] It is central to the success of this strategy that expert directors should comprise a *minority of the board*. Limiting such representation to a minority slate assures management that there is no immediate threat of a change in control, yet assures that a minority of directors have the distance and incentive to ask hard questions.[15]

The moderate nature of the constructive engagement strategy is underscored by what happens if management and the minority directors disagree. In that event, the decision-making balance rests with the traditional outside directors, a group that studies have shown may not be effective in a proactive way, but is quite effective when a crisis shifts decision making authority and corporate resources to them.[16] A disagreement between management and minority directors thus elicits action by traditional outside directors in precisely the setting in which they have been most

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12. *See, e.g.*, Randall Morck et al., *Do Managerial Objectives Drive Bad Acquisitions?*, 45 J. FIN. 31 (1989); Amar Bhide, *The Causes and Consequences of Hostile Takeovers*, J. APPLIED CORP. FIN., Summer 1989, at 36; Sanjai Bhagat et al., *Hostile Takeover in the 1980s: The Return to Corporate Specialization*, *in* 1990 BROOKINGS PAPERS ON ECONOMIC ACTIVITY, MICROECONOMIC 1; Robert Comment & Gregg Jarrell, Corporate Focus and Stock Returns (May 1991) (working paper No. 91-01, Univ. of Rochester).

13. *See* JOHN POUND, CORP. VOTING RESEARCH PROJECT, RAIDERS, TARGETS, AND POLITICS: CHARTING THE NEXT ERA IN AMERICAN CORPORATE CONTROL (Oct. 1991) (John Pound, a former SEC economist, is director of the Corporate Voting Research Project, at Harvard University's Kennedy School of Government); Ronald J. Gilson & Reinier H. Kraakman, *Reinventing the Outside Director: An Agenda For Institutional Investors*, 43 STAN. L. REV. 863 (1991).

14. *See* Gilson & Kraakman, *supra* note 13, at 883-92.

15. *Id.* at 888-89. The minority character of the representation should also be important to other shareholders, who will view the proxy contest quite differently if its goal is to provide an independent minority voice on the board rather than to change the individuals responsible for running the corporation's business.

16. *See* JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 98-139 (1989).

effective.

A minority representation strategy, which we have advocated both in scholarship and through direct corporate action,[17] should be relatively noncontroversial because it minimizes the threats inherent in the confrontational tactics of the 1980s—the goal is to monitor management, not replace them. And because it contemplates the constructive engagement of large shareholders in the ongoing corporate governance process,[18] it should meet a more receptive regulatory reception as well.

At this point the irony which motivates our effort arises. The regulatory barriers to proposing and electing a *minority* of directors are dramatically *higher* than those confronting a proxy contest seeking to shift control by replacing the entire board. Precisely because this perverse outcome makes no sense, the regulatory barriers that cause it stand out starkly. Fortunately, they may be eliminated without making major—and, what recent experience indicates, controversial—changes in the proxy rules. Such a project is the best kind of reform, one that promises a large potential payoff from very little change.

Part I of this Article identifies the regulatory barriers to a proxy campaign seeking minority representation—the short slate problem and the bona fide nominee rule. Part II examines the flawed techniques available under the existing regulatory regime to avoid the problems caused by these barriers. Part III then suggests a simple amendment to the bona fide nominee rule that would alleviate the special barriers to electing a minority of directors.

II. Seeking Minority Board Representation Under the Current Proxy Rules

Imagine a long-term shareholder concerned about corporate performance or some aspect of corporate policy, who wishes to nominate director candidates to inject an alternative point of view into corporate decision-making. The shareholder does not wish to change control of the board; only minority representation is sought. Imagine further that management welcomes neither the shareholder's request for representation nor the proposed candidates, so that merely submitting the nominees to the board's nominating committee, if it has one, would not result in shareholders being given the opportunity to vote on the proposed nominees. In other words, management won't make it easy by including the shareholder's nominees on the proxy card distributed by the corporation. To succeed, the shareholder must independently circulate proxy materials, solicit votes in favor of the minority nominees,

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17. Lilli Gordon has developed strategy in four recent proxy campaigns based on minority representation. Gilson, Gordon, and Pound were co-sponsors, along with Carl Icahn, of a 1991 initiative to elect four independent director candidates to USX Corporation's fifteen-member board.

18. For other suggestions that shareholders have the ability to elect their own nominees for a number of board seats, *see, e.g.*, Louis Lowenstein, Sense and Nonsense in Corporate Finance 232 (1991), *reprinted in* Symposium, *Proxy Reform*, 17 J. Corp. L. 1, 22 (1992) (stating "institutional investors should be represented on the board by allowing them to nominate a few directors, not just elect those who have been nominated by management, and without having to fight their way in"); Elmer W. Johnson, *An Insider's Call for Outside Direction*, Harv. Bus. Rev., Mar.-Apr. 1990, at 46.

and secure enough votes to win.

At first glance, the process of pursuing minority board representation appears to be relatively simple. The shareholder must file with the Securities and Exchange Commission a proxy statement containing the information required by Schedule 14A, together with any supporting materials to be circulated to shareholders and a proposed proxy card.[19] The shareholder must also file Schedule 14B disclosures with respect to any director candidate who will actually speak with shareholders in conjunction with the solicitation.[20] After the SEC reviews the filings, the shareholder may circulate the soliciting materials and proxy card, and pursue the election of the minority director candidates.[21] When the solicitation is completed, the shareholder then attends the annual shareholder meeting, nominates the proposed director candidates, and casts the proxy votes that have been acquired in favor of those candidates. At this surface level of generality, and subject to a relatively high minimum cost threshold—which deters everyone whose potential to improve the corporation's governance does not outweigh collective action costs—any shareholder can nominate, solicit votes for, and elect new minority directors to the corporate board, provided a sufficient number of shareholders can be persuaded to vote for them.

The story becomes more complicated, however, under the much more arcane pattern of state law, corporate charters, and federal proxy rules that govern the nomination of candidates, solicitation of votes, and election at specific corporations. Combined, these rules make it quite difficult for interested shareholders to nominate and successfully elect a slate of directors *that is fewer in number than the total number up for election*. Such a slate of directors is termed a "short slate." The next section provides a description and formal representation of the short slate problem, and a discussion of how the SEC's bona fide nominee rule prohibits the most straightforward solution.

A. The Short Slate Problem

The short slate problem is inherent in any majority-rule election in which an outside shareholder nominates a smaller number of candidates than the total up for

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19. Rule 14a-6, 17 C.F.R. § 240.14a-6 (1991), requires the filing of the proxy statement, supporting materials, and the proxy card. Rule 14a-3, 17 C.F.R. § 240.14a-3 (1991), requires that the proxy statement contain the information specified in Schedule 14A. Schedule 14A, 17 C.F.R. § 240.14a-101 (1991), in turn, specifies such matters as the identity of the persons making the solicitation, the revocability of the proxy, the methods and cost of solicitation, and a short professional history of the director nominees and, if incumbents, their compensation.

20. Schedule 14B, 17 C.F.R. § 240.14a-102 (1991), requires disclosure of the identity and background of the participant, the participant's interest in the issuer's securities, the nature and extent of the participant's involvement in the proxy contest and the relationship between the participant and the issuer.

21. Rules 14a-6, 14a-11, 17 C.F.R. §§ 240.14a7, .14a11 (1991), do not require that the participant receive SEC approval before it may circulate solicitation materials to shareholders. Rather, they mandate a waiting period—ten business days for proxy materials and two business days for supporting materials under Rule 14a-6—before distribution to shareholders. However, it would be quite unusual for a party to distribute its materials, even after the waiting period had expired, without first having received SEC staff comments. Thus, the waiting period operates much like a de facto approval requirement.

election. For firms with unclassified boards that re-elect all directors annually, the problem is not restricted to minority representation; it arises with any slate comprised of fewer director nominees than there are directors on the full board.[22] The short slate problem is less critical in firms with classified boards. Such firms elect only a fraction (usually one-third) of directors annually, so that one seeking only a minority of the total board may often contest all seats up for election and thereby avoid the problem. However, the problem does not entirely disappear even in the presence of a classified board if the company's board is large enough. Time-Warner's board, for example, consists of twenty-seven individuals classified into three equal cohorts; each annual election thus involves nine board seats. For a shareholder who seeks to inject fewer than nine new voices into the boardroom, the slate will be short even in the presence of the classified board.

Consider the mechanics of soliciting votes for a short slate in opposition to a management proxy listing a full slate of candidates for the board. To put the matter in context, assume the company's board is not classified and is comprised of fourteen incumbent members, each of whom is standing for re-election on a management slate. Further assume that the outside shareholder has nominated three candidates for whom votes will be solicited on a separate proxy card. Under standard corporate voting rules each shareholder is entitled to cast one vote for each of the director slots on the corporate board for each share held. Each share in our example thus has fourteen votes. Finally, assume the company does not have cumulative voting so that only one vote can be cast with respect to each of the fourteen board positions. The fourteen nominees receiving the highest number of votes are elected.

Now consider the alternatives confronting shareholders deciding how to vote in this contest. At first glance, it may appear that the shareholders have the same choices with respect to this short slate contest as they would if all fourteen board seats were contested: to vote either for all fourteen management nominees, or for the three-member dissident slate. However, the presence of the short slate presents a third possibility: shareholders may vote for the dissident's three-person short slate, and *also* vote for eleven of management's fourteen nominees. Through this strategy, shareholders can cast votes for all fourteen positions, and still support the dissident slate.

There are several reasons why shareholders who support the dissident slate are likely to take the third option and vote a "split ticket" in a minority representation campaign. First, such a voting strategy is consistent with the broad tenor of such campaigns. The point of offering candidates for only a minority of board seats is not to challenge the entire board. Shareholders who vote only for the short slate are effectively voting against all fourteen of management's candidates, as well as supporting the three candidates sponsored by the dissident shareholder. This voting strategy turns what is intended to be a mixed message—constructive engagement

22. Nonetheless, the primary impact of the short slate problem falls on one seeking minority representation. If control is sought, there is little difference between contesting a majority of board seats and contesting all seats.

but no change in control—into a "no" vote on the entire management slate. Second, by not voting at all for the other eleven director positions, the shareholder is foregoing the opportunity to indicate preferences among management's fourteen candidates. Even if the dissident slate is elected, so will eleven of management's candidates, with some being more qualified than others. Shareholders may conclude that voting only for the dissident candidates excludes them from a central focus of the election—deciding who will comprise a majority of the board.

It is at this point that the short slate problem emerges. If a significant fraction of all shareholders elect to split their votes, then the dissident's short slate is in serious trouble.[23] Suppose that 30% of the shareholders vote only for the short slate, 40% of the shareholders vote a straight management ticket, and the remaining 30% of the shareholders take the third option and split their votes, supporting the full dissident slate and eleven out of the fourteen management candidates. Suppose further that, in the aggregate, shareholders who split their votes select eleven candidates from among management's fourteen on a random basis—that is, such shareholders as a group do not favor any particular director, but allocate their votes across all fourteen management candidates with equal frequency.

A plausible first reaction might be that the dissident's short slate would prevail on these assumptions. Each of the three dissident nominees would receive the votes of 60% of the shareholders. The logic is that all three nominees, each having received more than a majority, would win seats on the board. In fact, all three dissident candidates would lose. Each dissident candidate would receive 60% of the vote, representing the combined votes of shareholders who support only the short slate and those who split their vote. However, management candidates also would receive votes from two groups of shareholders: the 30% of shareholders who support the dissident slate by voting a split ticket and who, as a group, vote randomly for eleven of management's fourteen candidates; and the 40% of shareholders who vote for all fourteen management candidates. The per candidate pro-management vote from the ticket-splitting shareholders vote would be 0.3 (the percent splitting their vote) multiplied by 11/14 (the average number of votes each ticket-splitting shareholder would cast for each management-sponsored candidate), or 23% for each management candidate. Each management candidate thus would receive 63% of the vote and the short slate nominees, who each receive only 60% of the vote, would lose.

This is an unexpectedly perverse aspect of the short slate phenomenon. We tend to think that majority voting rules are simple and straightforward, and that in any election one candidate will receive a majority and win, and the other a minority and lose. This is not the case in corporate elections with short slates because corporate voting rules give shareholders the right to vote for each director slot rather than a choice between a single "dissident" and a single "management" candidate. Short slates open up the possibility that both sides' director candidates will receive more

23. There is also a second procedural problem which relates to proxy revocation. Splitting proxy votes requires returning two proxy cards—one to management and one to the dissidents. The later card may invalidate the earlier one. *See infra* note 34 and accompanying text.

than a majority, and that a dissident's campaign to attain minority representation will fail despite having received a majority of votes.

This example is easily generalized. The following model is useful for broad analytic purposes because it allows analysis of a wide variety of potential voting outcomes with respect to short slates.

Let:

N	=	the number of board positions up for election;
N_d	=	the number of seats for which the dissident is running candidates;
V_d	=	the percentage of shares voted only for the dissident short slate;
V_s	=	the percentage of shares voted for the dissident slate but also for N-N_d management candidates (a split ticket);
V_m	=	the percentage of shares voted only for the management slate.

Assume, as in the previous example, that ticket-splitters distribute their votes randomly across management nominees. Of course, this is not a description of any individual shareholder's decision-making, but rather a characterization of their behavior in the aggregate, given that they will tend to vote for different director candidates.

The vote outcome is as follows.

Dissident nominees receive:	$V_d + V_s$
Management nominees receive:	$V_m + V_s\,[(N\text{-}N_d)/N]$

Table 1 below provides examples of outcomes in short slate election contests that differ across all four dimensions reflected in the formula: the percentage of director slots up for election that the dissident is seeking, the percentage of shares voted only for the dissident short slate, the percentage of shares voted only for the management slate, and the percentage of shares voted for a split ticket. In each case, the outcome of the vote clearly conflicts with the fact that the majority of shareholders prefer the election of the dissident nominees and some combination of management nominees to the election of management nominees alone.

Consider Case 1 in the Table. Here the dissident shareholder seeks to elect only a very small percentage of the board; this can be interpreted as the prototypical case in which the dissident seeks to gain only one seat on a 12-to-14 member board for the purpose of injecting a different opinion into corporate decision-making. Shareholders have responded to the dissident's proposal by registering overwhelming support—90%—for his director candidate. Concurrently, almost all shareholders have also chosen to vote for management candidates. This is entirely consistent with the spirit of a minority campaign where the dissident is seeking only a voice on the board. Shareholders would not want to throw away their remaining votes or repudiate the entire management slate. Rather, they would support some management-sponsored directors along with the dissident's proposal for minority representation.

In Case 1, only 10% of the shares do not support the dissident candidate and are voted exclusively for management nominees; fully 90% of the shares are voted for the dissident's director candidate. The result, remarkably, is that the dissident director candidate receives the votes of 90% of all shares, but still loses.

The example depicted in Case 4 of the Table represents the other end of the spectrum in terms of goals and outcome. In this example, the dissident seeks 50% of the board—not control, but an equal voice with management. This clearly represents the limit of minority representation, as opposed to a contest for actual control. The dissident receives the voting support of a majority—51%—of the shares. In keeping with the more strongly "either/or" message inherent in a 50% representation campaign, only slightly over 7% of the shares (15% of all shares voted for the dissident) are also voted for a split ticket.

The dissident loses in this example too. Once again, the contravention of shareholder preferences is quite remarkable. Fifty-one percent of all shareholders indicated their preference that the dissident be given half the board, presumably because of the need to impose a check on management's current policies. Yet that clear message is defeated in the voting outcome. Management retains full control of the board, and the dissident receives not a single seat, despite receiving the support of a majority of shares.

The remaining two cases in the Table reflect intermediate cases between these extremes. Both embody the same contradiction as the more extreme cases. In every case, the dissident loses, despite a voting pattern that unambiguously signals shareholder support for the dissident's campaign.

Table 1

	Percent of Director Slots Contested by Dissident	Percent of Shares Voted Only for Mgmt. Slate	Percent of Shares Voted Only for Dissident Slate	Percent of Shares Voted for a Split Ticket	Percent of Shares Voted for Dissident Slate	Percent of Shares Voted for Each Mgmt. Nominee	Dissident Wins?
	N_d/N	Vm	V_d	V_s	$V_d + V_s$	$V_m + V_s [(N-N_d)/N]$	
Case 1	7%	10%	3.6%	86.4%	90%	90.4%	No
Case 2	20%	25%	11.25%	63.75%	75%	76%	No
Case 3	30%	40%	15%	45%	60%	71.5%	No
Case 4	50%	49%	43.35%	7.65%	51%	52.85%	No

B. The Bona Fide Nominee Rule

There is an easy and straightforward solution to the short slate problem. The problem occurs because, as a group, ticket splitting shareholders allocate their votes across all management candidates, in our original example voting randomly for eleven of the fourteen incumbent nominees, rather than voting for eleven specific incumbents. The obvious solution is for the dissident to run a full slate, rather than a short slate, of directors. The full slate would consist of the dissident's own three nominees, and the eleven management nominees that the dissident believed were best qualified to continue to serve on the board. Such a slate would offer shareholders a voting choice that is superior in virtually every way to that available in a pure short slate campaign. Shareholders would be offered two coherent alternatives on the composition of the board of directors, each of which was fully described and without uncertainty. These choices would allow the dissident to take a positive position on the qualifications and relative expertise of management's nominees, and create a less polarized set of alternatives.

Most importantly, the perverse outcome observed in each of the short slate cases—all dissident nominees losing despite receiving a majority of the vote—would not occur. As in the original example, the dissident's slate would still receive 60% of the vote. The difference is in the votes received by the incumbents. The eleven incumbents listed on both the dissident and the management slate each receive 100% of the vote cast (from the 40% of shareholders who vote a straight management ticket and the 60% who now vote a split ticket).[24] The remaining three incumbents, however, receive only 40% of the vote—the votes cast for the straight management ticket. Thus, the three dissident nominees are now elected, beating the three targeted management nominees 60% to 40%.

The different outcome results from the fact that the votes of those supporting the dissidents by voting a split ticket are concentrated on eleven management nominees, rather than spread randomly (in the aggregate) across all fourteen members of the management slate. Running a full slate of which only three nominees are dissidents solves the short slate problem by focusing the attention of the ticket spitters. The same result occurs for each case shown in Table 1. The management nominees left off the dissident's full slate receive only the votes of those who voted the straight management ticket and therefore lose to the dissident candidates.

It is here that the micro-structure of the SEC's proxy rules come into play to block this straightforward solution. A dissident cannot run such a full slate, because the proxy rules prohibit a dissident from circulating a proxy card that includes any of management's nominees. In particular, the "bona fide nominee" rule prohibits a party from soliciting a proxy for director candidates who have not agreed to allow that party to use their names.[25] Under this rule, management simply needs to instruct its director candidates to refuse to allow their names to be listed on the dissident proxy. This leaves a dissident who had wanted to pursue a strategy of constructive engagement with two relatively unattractive choices: either run a short slate campaign, with all its attendant strategic problems, or run a full slate, composed entirely of dissident nominees, thereby turning a strategy of constructive engagement into a full scale control contest. A regulatory structure that mandates

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24. The 60% ticket-splitters in this example are comprised of the two groups who supported the dissident nominees in the original formulation of the examples: the 30% who voted for both the three dissident nominees and the 11 management nominees; and the 30% who voted only for the dissident nominees.

25. The "bona fide" nominee rule appears in Rule 14a-4(d), 17 C.F.R. § 240.14a-4(d) (1991), which provides, in pertinent part:

> No proxy shall confer authority (1) to vote for any person to any office for which a bona fide nominee is not named in the proxy statement . . . . A person shall not be deemed to be a bona fide nominee and he shall not be named as such unless he has consented to being named in the proxy statement and to serve if elected.

such a counter-intuitive result—encouraging confrontation by restricting cooperative initiatives—should be supported by a powerful justification. We are unable to discover or devise one.

The bona fide nominee rule provides an interesting example of a SEC requirement whose conceptual explanation fails to justify its perverse impact on shareholder efforts to elect a minority of directors. Our best conjecture concerning the rule's goal is to prevent dissidents (or management) from running dummy director candidates. Conceivably, opportunistic managers or challengers might seek to mislead voters by placing director candidates on their proxy who had not assented or did not intend to serve. One possible ploy involves using "big names" to secure a vote, then announcing after the vote that these individuals had refused to serve or had resigned and would be replaced, presumably by cronies.[26] To be sure, no soliciting party should be allowed to ask shareholders to vote for individuals who had not assented, or indeed had refused, to serve. However, the bona fide nominee rule is unnecessary to prevent such a scheme. Rule 14a-9 independently prohibits false or misleading proxy solicitations[27] and it is hard to imagine a more misleading solicitation than one for a make believe candidate.

Alternatively, one might seek to justify the requirement that a nominee consent to a solicitation on his or her behalf not because the nominee is make-believe, but because the nominee will decline to serve as a director if the dissident nominees also are elected. But this justification of the bona fide nominee rule also seems beside the point. Recall that the rule requires a nominee to consent "to serve if elected." Thus, management nominees who took the position that they would not serve on the same board as dissident nominees if both were elected would themselves not satisfy the bona fide nominee rule.[28]

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26. The allegations considered in *In re* Charles A. Massie, Exchange Act Release No. 3944, [1945-47 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 75,771 (Apr. 12, 1947), represent the extreme version of such a ploy. The SEC charged that as part of a scheme to divide control of a company, two parties agreed that one would name seven board candidates and the other would name six, but with the former securing in advance the undated resignation of one of his seven candidates. After the election, the resignation would be used and the remaining 12 directors would fill the vacancy. The claim was that the candidate who had already submitted a resignation was not a bona fide nominee.

Aegis Corp. v. Goldman, 523 F. Supp. 1273 (S.D.N.Y. 1981), is a more recent example of this phenomenon. In *Aegis*, a large shareholder had solicited proxies to be voted against a management sponsored stock option plan and also had secured discretionary authority to vote the proxies with respect to unanticipated matters. *Id.* at 1274-75. At the last moment the shareholder decided to seek control of the company and at the shareholders' meeting intended to vote the proxies in favor of his own motion to increase the size of the board of directors. *Id.* He would then vote only his own shares for his nominees to fill the newly created vacancies. Because the shareholder had not solicited proxies on behalf of bona fide nominees for the newly created vacancies, his proxies could not be voted for this purpose. *Id.* The shareholder's nominees nonetheless would be elected because the proxies held by management could not be voted for additional nominees for the same reason. *Id.* The court collapsed the shareholder's two step plan, holding that the shareholder's voting the proxies in favor of expanding the board had the inevitable effect of electing persons who had not been named as bona fide nominees in the shareholder's proxy statement. *Id.* at 1279-80.

27. 17 C.F.R. § 240.14a-9(a) (1991).

28. *See infra* text accompanying note 38.

That the application of the bona fide nominee rule to prevent dissidents from listing management nominees on their proxy card is without justification is the good news. The bad news is that the application has a significant, damaging, and presumably unintended consequence. It prevents shareholders who are seeking to elect a minority of directors from soliciting proxies for management nominees who are very clearly bona fide in that they have consented to be nominated for the board, and who have not stated that they would decline to serve if the minority of dissident candidates were also elected.[29] These individuals ought to be fair game on anyone's proxy, which, after all, simply functions as an absentee ballot for a corporate election. Moreover, sensible public policy should dictate precisely this result. As applied, the bona fide nominee rule has the perverse effect of encouraging contests for control of the board rather than encouraging efforts by dissidents to constructively engage management.

Two categories of corporations do not present the barriers to constructive engagement created by the interaction of the short slate problem and the bona fide nominee rule. The first category is corporations that have cumulative voting, which was once widespread but is now a diminishing phenomenon under changing state laws and corporate charters.[30]

Under cumulative voting, shareholders may cast for each share held as many votes as there are director slots up for election, distributing their votes over the slots as the shareholder wishes, including, in the extreme, casting all votes for a single candidate. Thus, in the original example having three dissident nominees with fourteen director slots up for election, cumulative voting allows shareholders to elect the dissident nominees by dividing all fourteen votes among just the dissident nominees. If the ticket-splitting shareholders in the original example acted under cumulative voting rules and divided all their votes among only the three dissident nominees, the three dissident nominees would be elected along with eleven management nominees.

The second, and more interesting, category is corporations with classified boards. In recent years, board classification proposals have become a familiar element of management's array of anti-takeover devices.[31] The idea is simply that if the board is divided into three classes with three year terms, one of which is elected annually, a raider will need two elections to replace a majority of the board.[32] Ironically, management's effort to protect against a hostile takeover serves to make the corporation more congenial to a constructive engagement strategy. So long as the

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29. Management would not urge its nominees to take this position even if the bona fide nominee rule allowed it. If the dissident nominees were elected, the result would be to turn over complete control of the corporation to the dissidents. The successful dissident nominees would then be in a position to fill the vacancies created by the management nominees who declined to serve. *See infra* text accompanying note 39.

30. *See* Sanjai Bhagat & James Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J.L. & ECON. 339, 343-44 (1984).

31. For evidence on the prevalence of classified boards, see INV. RESP. RES. CTR., DIRECTORY OF TAKEOVER DEFENSES (1991) (stating that about ½ of publicly traded corporations have classified boards).

32. Under Delaware law, directors on a classified board can be removed only for cause. DEL. CODE ANN. tit. 8, § 141(k)(i) (1991).

board is small enough, a dissident may seek minority representation by nominating a *full* slate with respect to the class of directors being elected in any one year. In the end, this may constitute the best argument in favor of classified boards. Classified boards at least create the strategic possibility of incremental change based on minority representation, rather than sudden and complete shifts in the entire composition of the board.

III. Living with the Problem: Partial Cures Under the Current Rules

A number of partial solutions to the short slate problem are possible under the current proxy rules, all of which have been observed in recent proxy seasons. Unfortunately, all of them still subject a shareholder pursuing a strategy of constructive engagement to a perverse regulatory disadvantage compared to launching a proxy fight for complete control. Thus, they are poor substitutes for the simple reform of the proxy rules that is necessary to fully solve the problem. We describe these partial solutions in this part both to contrast them to the real reform proposed in the next part and, in the meantime, to call them to the attention of any shareholders who may be contemplating running minority slates in the period before the SEC corrects the regulatory problem once and for all.

A. Run Against Specific Management Candidates: A "Quasi-Full Slate" Strategy

A first alternative open to dissidents pursuing a short slate constructive engagement strategy is to persuade ticket splitting shareholders to mark management's proxy card in a specified way. In our earlier textual example, shareholders should vote for eleven specific management nominees, and should withhold their vote from three specific management nominees. If ticket-splitting shareholders follow this advice, the short slate problem does not arise because the three targeted management nominees receive votes only from shareholders voting a straight management slate and do not receive a share of the ticket splitters' votes—the core of the short slate problem. Therefore, in our original example, the result is the same as if the dissident ran a full slate composed of three dissident candidates and eleven management candidates. In both cases, the dissident elects three nominees. The three management candidates deemed least qualified will receive fewer votes than the other management candidates, and fewer votes than the minority slate.

Three serious problems exist with running a "quasi-full slate" campaign. First, it emphasizes "negative campaigning" directed at specific individuals in the context of a strategy intended to stress constructive engagement rather than conflict. To convince shareholders to withhold their votes from particular management candidates, the dissident must devote considerable time and effort to demonstrating that the minority of dissident candidates are qualified and that specific management candidates are not. Such a campaign opens the dissident to the charge of personal attack, and allows management to shift the debate from the need for a new, albeit, minority perspective in the boardroom to whether the targeted management candidates are "bad" directors. In addition, attempts to discredit specific management nominees are likely to attract significant SEC staff scrutiny, and invite litigation, because of Rule 14a-9's direct admonitions against character attacks in proxy campaigns.[33]

A second problem with running a "quasi-full slate" campaign by opposing specific management nominees is complexity. Such a campaign must convince busy and relatively uninformed shareholders to make a very specific and mechanically complex set of voting decisions. They must first vote for the dissident slate on the dissident's proxy card. Then on management's proxy card they must vote for certain members of management's slate and withhold their votes with respect to the specific management candidates the dissident has targeted. Ticket splitting shareholders have a number of ways to make mistakes. They may simply forget for which management nominees they are not supposed to vote. Or they may mistakenly vote for too many management candidates, thereby casting too many votes overall. In our original example, ticket splitting shareholders might support the dissident's short slate of three, but vote for twelve rather than eleven management nominees whether through mechanical error or because they failed to understand the consequences of not withholding their vote from all of the targeted management candidates. In that event, both proxies—the dissident card and the management card—would be invalid because the shareholder cast votes for more than fifteen directors.

The third problem is a procedural one relating to proxy revocation. In order to split their votes between a management's full slate and a dissident's short slate, shareholders must send back two proxy cards—one to management, and one to dissidents. This immediately creates a problem because, as a matter of practice, proxies are written so that a later-dated proxy card automatically revokes, in full, an earlier-dated card. Thus, suppose that a shareholder signs proxy card with respect to a eleven management directors on Tuesday, and signs a proxy card with respect to voting for the three dissident candidates on Wednesday. By executing the dissident proxy, the eleven management votes are automatically revoked. This problem can potentially be overcome. However, the solutions are awkward, error prone, and may create additional problems themselves.[34]

Our experience in proxy contests suggests that it is difficult enough to ensure that shareholders properly fill out and return one proxy card with no choices. The complications associated with a "quasi-full slate" campaign are a serious barrier to success.

B. Partial Revocation

Partial revocation is an alternative to the quasi-full slate strategy that allows dissidents to specify those specific management nominees for whom ticket splitters

33. The note to Rule 14a-9, 17 C.F.R. § 240.14a-9 (1991), highlights as an example of what may be misleading: "Material which directly or indirectly impugns character, integrity or personal integrity."

34. One might date both the management and dissident proxies identically. However, we have been told by attorneys who have investigated this tack that the SEC staff has suggested that the two proxies would have to be accompanied by a letter stating that the shareholder intended both proxies to be valid, lest each party argue that the other's proxy was a mistake.

should not vote, with less chance of mechanical mistake due to the unavoidable use of two proxy cards. In a partial revocation campaign, the dissident's proxy card lists the minority slate, and also contains a separate box that, if checked, revokes a shareholder's management proxy for certain specific directors.[35] The dissident's card thus accomplishes two goals simultaneously: it solicits votes for the dissident's nominees, and results in withholding votes for specific management-sponsored directors equal in number to the number of dissident nominees. Of equal importance, the partial revocation strategy significantly reduces the potential for shareholders to make mistakes that would result in the voiding of all of their votes, including those for the dissident nominees. As long as a shareholder votes for all of management's nominees, all of the dissident nominees, and checks the revocation box on the dissident card, the vote comes out correctly without the shareholder having to remember which of the management nominees have been targeted. To our knowledge, partial revocation cards were first used in a dissident campaign at Zenith in the spring of 1990.[36]

Partial revocation campaigns are clearly preferable to pure run-against campaigns, and are at least a short-term improvement over a quasi-full slate strategy. However, partial revocation campaigns still present two serious problems. First, the campaign remains negative in character, and in that respect is inconsistent with a goal of constructive engagement. Second, and more importantly, the partial revocation approach invites a similar strategic response by management. For example, management may follow the dissident's partial revocation solicitation with its own solicitation that revokes the dissident's partial revocation card. A Suessean cycle of partial-partial revocation proxy cards may then ensue, whose complexity and chronology will mystify the most sophisticated proxy solicitor, let alone relatively uninformed shareholders and inspectors of election. The first use of the partial revocation concept in the Zenith contest had the advantage of strategic surprise. As the technique becomes more familiar, it will be anticipated by management planners and a series of clever defenses will once again substitute strategic gaming for process. In the end, clever gimmicks have a short life span.

C. *Expand the Board*

A different kind of alternative to an explicit campaign to replace specific management directors is to seek to expand the board and add new nominees. Ideally, such a strategy would have the additional benefit of avoiding a negative orientation because no incumbent directors would be targeted for replacement. Instead, the result would be only the addition of skills and perspective to the board.

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35. In theory, one could solicit an irrevocable proxy. These are uncommon in practice, presumably because shareholders would be reluctant to give up their ability to change their votes later in the campaign in response to new information.

36. Nycor, the dissident shareholder, prepared a proxy card by which shareholders could support its three nominees for Zenith's ten-member board. That card contained a box which, if checked, would revoke any previously-signed management proxy *only* as it pertained to three specific directors. Two of the authors advised the dissident in connection with the development of this strategy.

Unfortunately, board expansion campaigns are also subject to serious strategic shortcomings. Most important, board expansion is simply impossible at many corporations because bylaw provisions prohibit shareholders from determining board size. In addition, expansion campaigns, like a partial revocation strategy, are also subject to strategic gaming by management. For example, a shareholder proposing to expand the board by three members may be met with a management slate containing three new nominees to oppose the three dissident expansion candidates. Once again, the dissident would be forced into a "run-against" posture. Therefore, while a board expansion strategy is an attractive possibility in certain restricted circumstances, strategic uncertainty and widespread prohibitions on shareholder's ability to change board size make it a very limited tool.

D. Precatory Proposals

Submitting precatory shareholder proposals urging management to change board size, composition, or representation is an additional alternatives at many large corporations with concentrated institutional ownership. In the increasingly politicized world of institutional voting, management is in the end likely to endorse any proposal approved by shareholders, both to avoid the stigma of losing in the implicitly threatened non-precatory campaign that will be pursued if management ignores the precatory resolution, and to retain some influence over the actual outcome. Moreover, some institutional investors may prefer a precatory proposal to a mandatory contest because it allows them to pressure management as a group without actually voting against specific management candidates. Two of the authors developed several such precatory proposals for dissident shareholders last proxy season. One such proposal urged that the dissident—a 15% shareholder—be allowed to appoint two directors to the board whose seats would vanish if the dissident sold his stake.[37]

The strength of the precatory approach is also its weakness. As an advisory proposal, it can be ignored by a recalcitrant management. In addition, the political sophistication of voters in all but the largest corporations may not be sufficient as yet to allow this approach to succeed. Similar to the other responses to the short slate problem canvassed in this Part, precatory proposals are at best an imperfect approach to offering shareholders a true alternative kind of board representation.

IV. Paths to Reform

The clearest and most direct way to address the short slate problem and to ease the strategic difficulties associated with short slate campaigns is to reform the bona fide nominee rule. In this Part, we describe a simple amendment to Rule 14a-4(d) that solves this problem.

We propose that the bona fide nominee rule be narrowed to prohibit solicitation of proxies *only* with respect to director candidates who have not consented either to

37. This proposal was made by dissident investor Harold Simmons in his second proxy contest at Lockheed in 1991. One of the authors (Lilli Gordon) assisted in developing the proposal.

being named in the proxy statement of *any* soliciting party or to serve as a director if elected. The change allows a candidate's name to be included on the proxy card of any soliciting party—not just the party who proposes to nominate the candidate. As a result, dissidents seeking to elect a minority of directors could form a full director slate simply by adding those management sponsored nominees who they believed to be best qualified to the list of the dissident nominees on their proxy card. Shareholders could then vote for a full slate of directors on a single proxy card. The short slate problem would be solved without introducing the mechanical and strategic difficulties associated with the partial solutions canvassed in Part II. Moreover, the necessary alteration in the language of Rule 14a-4(d) is limited to a single word. The phrase "unless he has consented to being named in *the* proxy statement" would be changed to substitute the word "any" for the word "the". The operative phrase would then read "unless he has consented to being named in *any* proxy statement."

We can anticipate the most obvious objection to our proposal, what we call the "not with those people I won't" position. The argument is that some management nominees might state that they would not serve as directors, even if elected, if any dissident nominees also were elected. In our view, this is a make weight argument. In the face of a dissident campaign for a minority of board seats, the one outcome of which we are reasonably confident is that management would *not* nominate directors who would decline to serve if both they and the dissident nominees were elected.[38] Suppose nine "conditional" management nominees—we'll serve only on the condition that all the dissidents lose—and three dissident nominees are elected to a twelve person board. If the nine management nominees then decline to serve, the vacancies would be filled by the three dissident directors.[39] The result would be, quite literally, to give complete control to the dissidents. This hardly seems an optimal strategy for management.

Even were management to pursue such brinkmanship, the problem can be handled by a simple piece of disclosure. The conditions under which a director nominee is willing to serve is obviously material to a shareholder's voting decision. Any party soliciting proxies for a director that has conditioned his or her willingness to serve if elected should include those conditions as a part of the proxy statement, whether the soliciting party is management or a dissident. Indeed, it is hard to imagine that such disclosure is not required under current law.[40]

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38. *See supra* text accompanying note 28. Such a position seems to violate the current text of the bona fide nominee rule which requires that a nominee on whose behalf proxies are solicited has consented "to serve if elected." The difference goes to the heart of the real problem at which the bona fide nominee rule is directed: shareholders being forced to vote for a candidate who may *not* be the individual who will actually fill the position. *See supra* text accompanying note 26.

39. DEL. CODE ANN. tit. 8, § 142(e) (1991).

40. Current SEC staff practice appears to require that a dissident running a short slate must disclose that election of the dissident candidates may result in the refusal of elected management nominees to serve on the board. DIVISION OF CORPORATE FINANCE, SECURITIES AND EXCHANGE COMMISSION, PROXY REFERENCE MANUAL 33 (1984), *discussed in* PAUL RICHTER, PROXY CONTEST HANDBOOK (1989). It does not appear that management nominees are required to disclose the conditions under which they will not serve if elected, nor is there discussion of why such conditions would not violate the bona fide nominee rule.

Our proposed reform of the bona fide nominee rule is quite simple in scope but potentially far-reaching in effects. By allowing all soliciting parties to include on their proxy cards the names of any bona fide nominee, our reform would facilitate efforts by shareholders to participate constructively in the corporate governance process by seeking minority board representation rather than control. Our hope is that corporate governance activity in the 1990s takes the constructive turn appropriate to an era in which the focus of organizational energy should be on building structures that work rather than dismantling ones that do not. The present form of the bona fide nominee rule is an unjustified barrier to that desirable change in the focus of corporate governance activity.

V. CONCLUSION

The nomination and election of a minority of expert, shareholder-sponsored directors is a particularly attractive way for shareholders to address long-term incentive and performance problems within the corporation in a constructive, rather than confrontational, manner. However, the current proxy regulatory regime imposes strategic barriers to pursuing a program of constructive engagement. The bona fide nominee rule forces shareholders to run short slates composed only of their own nominees, rather than full slates made up of a minority of their own nominees and a majority of management nominees. As a result, shareholder proposed short slates may receive majority votes, yet still lose—hardly a result in keeping with an efficient system of shareholder oversight.

In this article, we have described and formalized the short slate problem, canvassed the options that are available to shareholders within the existing regulatory regime, and proposed a simple regulatory reform that solves the problem. In the course of its ongoing review of the proxy process, the subject is well worth the SEC's attention.