Why Proxy Access is Harmful to Corporate Governance

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I. INTRODUCTION

Traditionally, the nomination of directors has been under the control of the board of directors and its nominating committee.¹ In this role, the board is to evaluate the characteristics of the existing management team and incumbent board members and the challenges and opportunities facing the corporation and then take these factors into consideration when nominating director candidates.² However, this traditional function of

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¹. See NYSE, LISTED COMPANY MANUAL § 303A.04(a) (2010), available at http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp%5F1%5F4&manual=%2Fbc%2Fsections%2Fcm%2Dsections%2F (listed companies must have a nominating/corporate governance committee composed entirely of independent directors); NASDAQ, LISTING RULES IM-5605-6(e) (2010), available at http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F4%5F2&manual=%2Fnasdaq%2Fmain%2Fnasdaq%2Depotrules%2F (“(1) Director nominees must either be selected, or recommended for the Board’s selection, either by: (A) Independent Directors constituting a majority of the Board’s Independent Directors in a vote in which only Independent Directors participate, or (B) a nominations committee comprised solely of Independent Directors.”).

². ELAINE BUCKBERG & JONATHAN MACEY, REPORT ON EFFECTS OF PROPOSED SEC RULE 14A-11 ON
the board is now being challenged by new federal legislation and recently promulgated Securities and Exchange Commission (SEC) rules that support providing co-responsibility for this function with shareholders. Section 971 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) amended Section 14(a) of the Securities Exchange Act of 1934 (Exchange Act) to permit the SEC to adopt rules that will allow shareholders access to a public company’s proxy solicitation materials for purposes of nominating their own directors. That is, certain shareholders would gain the ability to place their director nominees alongside the board’s slate of director nominees in the company’s proxy card and proxy statement (proxy access). In response, the SEC promptly issued Rule 14a-11.


3. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010). Section 971 provides the SEC with undisputed authority to use its authority to promulgate proxy access rules as long as it can be justified on the grounds that it is “in the interests of shareholders and for the protection of investors”:

(a) PROXY ACCESS.—Section 14(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78n(a)) is amended—

(1) by inserting “(1)” after “(a);” and

(2) by adding at the end the following:

“(2) The rules and regulations prescribed by the Commission under paragraph (1) may include—

“(A) a requirement that a solicitation of proxy, consent, or authorization by (or on behalf of) an issuer include a nominee submitted by a shareholder to serve on the board of directors of the issuer; and

“(B) a requirement that an issuer follow a certain procedure in relation to a solicitation described in subparagraph (A).”.

(b) REGULATIONS.—The Commission may issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer, under such terms and conditions as the Commission determines are in the interests of shareholders and for the protection of investors.

Id. The providing of such statutory authority to the SEC in the Dodd–Frank Act was necessary to erase any doubts that the SEC had the authority to promulgate proxy access rules that arose in an over 20 year old decision involving the Business Roundtable. See Jill E. Fisch, The Destructive Ambiguity of Federal Proxy Access 3 (Inst. for Law & Economics, University of Pennsylvania Law School, Research Paper No. 11-05, 2011), available at http://papers.ssm.com/sol3/papers.cfm?abstract_id=1769061 (citing Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (arguing that the SEC does not have authority to interfere with the substantive features of company voting rights as established under state corporate law)).

4. A public company or publicly held firm is an economic organization in which: (i) management and shareholding are separable and separated functions; (ii) the shares are held by a number of persons; and (iii) the shares are freely transferable. Michael P. Dooley, Two Models of Corporate Governance, 47 BUS. LAW. 461, 463 n.9 (1992).

A key aspect of Rule 14a-11 was that it required proxy access at all publicly traded companies. Public companies were not allowed to opt-out of the proxy access rules. This one-size-fits-all approach to corporate governance is much reviled among corporate law scholars and practitioners who believe that a very important reason why corporate law is wealth enhancing is because it allows for private-ordering. That is, company officials and investors are in a much better position to determine the optimal corporate governance arrangements of their company than public officials. In addition, federally mandated proxy access eliminates the benefits of our federalist system from this area of corporate governance. As Justice Brandeis so eloquently stated many years ago, “a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.” The proxy process will be less effective without state experimentation because, even if proxy access can be argued to be good for corporate governance, there is good reason to believe that Rule 14a-11 was not the optimal default rule.

The imposition of a mandatory regime of inefficient corporate governance rules as provided for in Rule 14a-11, no matter what the will of the majority of shareholders or the individual needs of a particular firm, is wealth reducing. This suggests that a better approach to proxy access would have been to provide public companies the option to opt-in or at least opt-out of Rule 14a-11. Nevertheless, the SEC was quick to embrace mandatory proxy access.

Why the SEC would so quickly embrace rules that have a wealth reducing effect is a reflection of the growing political power of those that support mandatory proxy access. This is evidenced by the inclusion of Section 971 in the Dodd–Frank Act, even though there are no facts to support the argument that proxy access will enhance financial stability, and the changing make-up of SEC Commissioners from a Republican to Democratic majority that might be viewed as value-maximizing at each company subject to the proxy access rules, the Commission would have to guess at the appropriate default rule.”

(finding that the SEC acted arbitrarily and in violation of Administrative Procedures Act).


7. As will be subsequently described, the value of private-ordering must be understood in the context of maintaining a strong centralized authority for purposes of decision-making. See infra notes 60–81 and accompanying text (describing the impact of private-ordering in a big picture context). This limits the amount of private-ordering that can actually take place. As Professor Brett McDonnell noted, the law makes it very “hard to opt out of the presumption favoring board authority.” Brett H. McDonnell, Professor Bainbridge and the Arrowian Moment: A Review of The New Corporate Governance in Theory and Practice, 34 Del. J. Corp. L. 139, 149 (2009). However, this is not the case for a close corporation which can elect to be governed by its shareholders and therefore can act very much like a partnership if its certificate of incorporation so provides. See Del. Code Ann. tit. 8, § 351 (2006) (explaining that a certificate of incorporation may provide that the business will be managed by the shareholders).


9. The struggle between state and federal authority over the nomination of a public company’s directors has been going on for over 70 years. For a history of proxy access over the last 70 years, see Fisch, supra note 3, at 4 (describing the 70 years leading up to the federal proxy access rule and the impact of the new rule).


11. See Grundfest, supra note 8, at 366 (“B]ecause the Commission has no particular insight as to the preferences of the shareholder majority that might be viewed as value-maximizing at each company subject to the proxy access rules, the Commission would have to guess at the appropriate default rule.”).

12. Id.

13. Id. at 362.

14. According to the preamble to the Dodd–Frank Act, the purpose of the Act is “[t]o promote the
Democratic majority, the political party which is strongly supported by the most vigorous advocates of proxy access, unions, and public pension funds.  

Enhancing the political support for proxy access has been the ongoing and growing shareholder empowerment movement. This movement has been fueled by the growing dominance of institutional investors in the investment of publicly held stock, helping to reduce investors collective action costs, which in turn has been fueled by a reduction in the collective action costs of institutional investors through the use of shareholder advisory services such as Institutional Shareholder Services; the increasing ability of activist hedge funds to raise large pools of funds so as to seek significant positions in public companies; perhaps, most importantly, the SEC’s ideological support of shareholder interests, which has led to the liberalization of communications between shareholders with respect to proxy voting, elimination of discretionary broker voting for the election of directors, and required disclosure of proxy voting by financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail’, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.” Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, preamble, 124 Stat. 1376, 1376 (2010).

15. Grundfest, supra note 8, at 379. Somewhat surprisingly, the Democratic Party does not have complete ownership of mandatory proxy access. Even though the push for mandatory proxy access received a huge boost from the election of President Obama, allowing for the SEC Commission to be made up of three Democrats and two Republicans (the three Democrats voted for proxy access while the two Republicans voted against), see Marcy Gordon, Proxy Access: SEC Gives Shareholders Greater Say On Corporate Board Seats, HUFFINGTON POST, Aug. 25, 2010, http://www.huffingtonpost.com/2010/08/26/proxy-access-sec-gives-sh_n_695263.html (describing changes to the nomination process of directors of public companies by shareholders), it should be remembered that William H. Donaldson, a Republican Chairman of the SEC, had proposed a limited form of mandatory proxy access during the Bush administration. Stephen Labaton, S.E.C. to Propose Change in Election of Boards, N.Y. TIMES, May 19, 2009, http://www.nytimes.com/2009/05/20/business/20sec.html.


17. Iman Anabtawi & Lynn Stout, Fiduciary Duties for Activist Shareholders, 60 STAN. L. REV. 1255, 1255 (2008) (“The most important trend in corporate governance today, however, is the move toward ‘shareholder empowerment.’”).

18. Collective action costs mean that “shareholders generally will not make an effort to effect governance changes unless the benefits resulting from the efforts equal or exceed the costs of such an effort. Even when such efforts are made, the benefits may only inure to a particular shareholder or a small group of shareholders.” Paul Rose, The Corporate Governance Industry, 32 J. CORP. L. 887, 897 (2007).

19. Anabtawi & Stout, supra note 17, at 1277–78. For an excellent discussion of the costs and benefits of proxy voting firms, such as Institutional Shareholder Services, see Rose, supra note 18.

20. See Anabtawi & Stout, supra note 17, at 1278 (discussing the rise of activist hedge funds).

21. Paul Rose, Common Agency and the Public Corporation, 63 VAND. L. REV. 1355, 1356–59 (2010). However, given that the SEC is a political institution which will be governed by a majority of Democrats or Republicans at any point in time, it must be expected that the SEC will have more or less interest in protecting the interests of certain shareholders, such as public pension funds and union affiliated pension funds, depending on which party is in control and how the political winds shift.


investment companies; and the newfound ability to use the populist argument that shareholders must take a more active role to constrain reckless risk-taking by corporate managers in order to prevent another financial crisis. In sum, it created a perfect storm for the support of mandatory proxy access.

Rule 14a-11 was to become effective on November 15, 2010. Fortunately, Business Roundtable and the U.S. Chamber of Commerce filed a lawsuit in the D.C. Circuit Court of Appeals asking the court to find the rules unlawful. An accompanying motion for a stay of the proxy rules resulted in the SEC granting the stay. The SEC acted wisely as the three judge panel of the D.C. Circuit Court of Appeals unanimously decided to vacate Rule 14a-11 after determining that the SEC acted “arbitrarily and capriciously” for not adequately assessing the economic effects of Rule 14a-11 as required by the Administrative Procedures Act. In response, the SEC decided not to seek a rehearing by the entire D.C. Circuit Court of Appeals or appeal directly to the Supreme Court. Instead, the SEC has removed the stay on amended Rule 14a-8(i)(8) and thereby has allowed shareholder proposals on proxy access to become part of a public company’s proxy materials. This is a major shift in SEC policy as the SEC’s long standing rule

25. Christopher M. Bruner, Corporate Governance Reform in a Time of Crisis, 36 J. CORP. L. 309, 332–35 (2010). This argument is not supported by any evidence that such shareholder empowerment would actually reduce reckless risk-taking in the financial sector or that such risk-taking was an issue in the non-financial sectors of the economy leading up to the financial crisis.
26. Brief of Petitioner at 1–2, Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011) (No. 10-1305), 2010 WL 3770710. The suit did not deny the authority of the SEC to promulgate proxy access rules it only asserted that Rule 14a-11 as written was in violation of federal law in numerous respects. Id. For example, the suit claimed that Rule 14a-11 was “arbitrary and capricious” and therefore in violation of the Administrative Procedure Act in estimating how often proxy access would be used, how it would be used by certain activist shareholders, and its treatment of state law. Id.

Would disqualify a nominee who is standing for election;

Would remove a director from office before his or her term expired;

Questions the competence, business judgment, or character of one or more nominees or directors;

Seeks to include a specific individual in the company’s proxy materials for election to the board of directors; or

Otherwise could affect the outcome of the upcoming election of directors.

32. SEC News Release, supra note 30. On September 15, 2011, the SEC published a release providing
has been that a company was permitted to exclude any proposal from its proxy materials relating to an election of directors. This change in policy has radically reduced the cost of getting proxy access proposals in front of a public company’s shareholders as the only alternative that shareholders could have previously used to present a proxy access proposal to other shareholders through the proxy process was to use their own solicitation materials under SEC Rules 14a-6 and 14a-12, which has historically been cost prohibitive. Public companies can now expect to receive proxy access proposals for the 2012 proxy season.

In essence, the proponents of private ordering have won, at least until the SEC decides to come back with its next version of mandatory proxy access. And for many, this is a satisfactory result. However, being satisfied with private ordering is not the end of the analysis. The next question that must be asked is whether proxy access is beneficial or harmful to the governance of a public company. If harmful, it makes no sense for the

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34. Under the old rule, a company was able to exclude from its proxy materials a shareholder proposal “[i]f the proposal relates to a nomination or an election for membership on the company's board of directors or analogous governing body or a procedure for such nomination or election.” 17 C.F.R. § 240.14a-8(i)(8) (prior to Sept. 20, 2011). The SEC’s source of authority for this long-standing exclusion comes from Section 14(a) of the Securities Exchange Act of 1934: It shall be unlawful for any person, by the use of the mails or by any means or instrumentalities of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy . . . .


35. 17 C.F.R. § 240.14a-6; id. § 240.14a-12.


37. The SEC is still faced with strong political pressure from institutional investor advocacy groups to make another attempt at implementing mandatory proxy access. See Letter from Council of Institutional Investors to Mary Shapiro, Chairman, SEC (Sept. 7, 2011), available at http://www.cii.org/UserFiles/file/resource%20center/correspondence/2011/09-07-11%20Letter%20to%20SEC%20on%20Proxy%20Access.pdf (expressing disappointment with the SEC’s decision not to file a petition for an en banc rehearing of Business Roundtable v. SEC but looking forward to working with the SEC on the Council’s number one priority, a new uniform proxy access rule).
SEC to require a company to put such proposals in their own proxy materials or for the SEC to revisit mandatory proxy access. This Article expects that proxy access will be harmful, leading to increased error in director nominations as decision-making is moved from the board of directors to shareholders who will make their nominations based on significantly less information. This Article further expects a shifting of the potential for other opportunistic behavior, such as the extracting of private benefits from the corporation, from an independent board and nominating committee to certain shareholders who, unlike directors, are not subject to fiduciary duties.

The SEC has erred in amending Rule 14a-8(i)(8). It has erred because it is now requiring companies to spend resources on facilitating the use of a fundamentally flawed tool of corporate governance, proxy access. Proxy access will only reduce the efficiency of corporate governance, not enhance it. Shareholders need to understand this before they vote on proposals to introduce proxy access into their respective company’s governing documents. Moreover, because of the harmful effects of proxy access, the SEC should drop its proxy access initiative in its entirety, including any future attempt at reintroducing mandatory proxy access.

The discussion that follows, when it references state corporate law, has been pragmatically framed in the context of Delaware corporate law. Delaware is the state where the majority of the largest U.S. companies are incorporated, and its corporate law often serves as the authority that other U.S. states look to when developing their own statutory and case law. Therefore, the primary examples are from Delaware, but the thinking is meant to be global in nature.

This Article proceeds as follows. Part II provides an overview of the SEC’s recently vacated mandatory proxy access rules as a model for what proxy access may look like if the SEC reintroduces mandatory proxy access or if it is proposed by a corporate shareholder under amended Rule 14a-8(i)(8). Part III utilizes an authority model of corporate governance to explain why proxy access is a very inefficient means to promote accountability in the corporate governance of a public company. Going forward, it is hoped that this non-empirical approach will be utilized in evaluating other corporate governance proposals that would shift corporate decision-making from the board of directors and executive management to shareholders. Part IV provides a short discussion

38. Opportunistic behavior is defined broadly to include both the decision-making limitations of corporate authority as well as managerial shirking or the extracting of private benefits from the corporation. See infra text accompanying note 139.

39. Such an action may ultimately unleash a plethora of shareholder proposals that shareholders would be required to vote on. See Lawrence A. Hamermesh, Random Thoughts on Proxy Access and Judicial Review, INST. OF DEL. CORP. & BUS. L. BLOG (Aug. 17, 2011), http://blogs.law.widener.edu/delcorp/2011/08/17/ random-thoughts-on-proxy-access-and-judicial-review/#more-152 (“[T]here is every reason to think that proxy access proposals will become as ubiquitous as majority voting initiatives . . . .”). One important reason why such a plethora of proposals may occur is because an investor only needs to hold $2000 worth of company voting stock for one year in order to submit a proposal on proxy access. 17 C.F.R. § 240.14a-8(b)(1).

40. See LEWIS S. BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE 1 (2007) (stating that Delaware is the “favored state of incorporation for U.S. businesses”). According to the State of Delaware web site, Delaware is the legal home to more than 50% of all U.S. publicly-traded companies and 63% of the Fortune 500. Why Choose Delaware as Your Corporate Home?, DEL. DIV. OF CORP., http://corp.delaware.gov (last visited Dec. 28, 2011).

of how to minimize the damage of proxy access if the arguments made in this Article do not win the day, and shareholders approve a proposal on proxy access or the SEC insists on taking another crack at mandatory proxy access. Part V provides a brief conclusion.

II. THE RECENTLY VACATED PROXY ACCESS RULES

It is important to remember that Rule 14a-11 was not vacated because the court disagreed with mandatory proxy access or how the rules were structured. Rather, the Rule was vacated because in the process of writing the rules the SEC acted “arbitrarily and capriciously” for not adequately assessing the economic effects of Rule 14a-11 as the Administrative Procedures Act required. Therefore, if and when the SEC proposes the next round of mandatory proxy access rules, it will most likely look very similar to Rule 14a-11. Moreover, proxy access proposed for any particular company as a result of Rule 14a-8(i)(8) may have similar parameters.

Under Rule 14a-11, shareholders would have been able to have their nominee included in the proxy materials if:

- They owned at least three percent of the total voting power of the company’s securities that are entitled to be voted in the election of directors at the annual meeting.
- Shareholders had been able to aggregate holdings to meet the three percent threshold.
- Shareholders had held their shares for at least three years.
- A shareholder had been able to include no more than one nominee, or a number of nominees that represents up to 25% of the company’s board of directors, whichever is greater.
- When a company had a classified (staggered) board, “the 25% calculation would still be based on the total number of board seats.”
- “Where there [were] multiple eligible nominating shareholders, the nominating shareholder or group with the highest percentage of the company’s voting power would have [had] its nominees included in the company’s proxy materials.”
- Rule 14a-11 was not available to shareholders seeking control of the company.
- “The nominating shareholder or group must [have] provided notice to the company of its intent to use Rule 14a-11 no earlier than 150 days prior to the anniversary of the mailing of the prior year’s proxy statement and no later than 120 days prior to this date.”

The rules applied “to companies that [were] subject to the Exchange Act proxy

44. Id.
45. Id. at 56,675.
46. Id.
47. Id.
49. Id. at 56,676.
50. Id. at 56,675.
rules, including investment companies [registered under Section 8 of the Investment Company Act of 1940] and controlled companies . . .”51 Smaller reporting companies, such as those with a public float of less than $75 million, would have been subject to the rule, but not until three years after the date that the rules become effective for larger reporting companies.52

The parameters provided in Rule 14a-11 are interesting to analyze on their own—especially whether or not the three-percent threshold and the three-year holding period are justifiable and on what grounds—and this Article will touch upon these topics in Part IV. However, the most noteworthy aspect of Rule 14a-11 was that it was to be mandatory for almost all public companies.53 What deference to federalism and private ordering the SEC allowed was extreme and essentially worthless, at least to those corporations who did not want to participate in proxy access. First, companies may have opted-out if their governing documents or the state corporate law under which they operate prohibited the nomination of directors by shareholders.54 As noted in the Release, however, the SEC was unaware of any jurisdiction that prohibited shareholders from nominating directors.55 Moreover, shareholders giving up the right to nominate directors in order to avoid mandatory proxy access is a high price for shareholders to pay, so it is very unlikely that they would have approved such a corporate governance change. For example, shareholders would not want to give up the right to enter into a proxy contest for control of the board when the situation warrants.56 Second, a company may partially opt-out if the company’s proxy access regime was less restrictive than required by Rule 14a-11.57 For example, if company guidelines provided that only two percent of voting stock is necessary for proxy access, then those shareholders with two percent of voting stock but under the three percent threshold required under Rule 14a-11 may have proceeded under company guidelines.58 As discussed in the next Part, however, even if Rule 14a-11 had been structured to be the optimal one-size-fits-all proxy access rule, the overriding problem with proxy access is that it is harmful to corporate governance.

III. Why Proxy Access is Fundamentally Flawed

Public companies can become very large in size both in terms of employment and investment in plant and equipment. For example, think of General Motors with over 200,000 employees and its massive investment in automobile factories in the U.S. and around the world.59 Why a corporation would decide to produce what it needs internally under a command and control structure—and thereby potentially grow to great size—and

51. Id. at 56,674.
52. Id. at 56,687 n.176.
54. Id. at 56,678.
55. Id.
58. Id.
not simply purchase from external sources, is a function of transaction costs and the marginal analysis that goes into determining which is the better alternative. In such a Coasean world, firm “managers continuously compare the incremental costs and payoffs of internal production (expansion or vertical integration) against external procurement, choosing whichever alternative provides the best payoff until the two are equalized at the margin.”

The point of optimal firm size and shape then becomes a function of this marginal analysis:

In The Nature of the Firm the comparative costs of the price mechanism, as Coase put it, explained its size and shape. Does it produce its own raw materials or buy them on the open market? Does it provide its own energy by building and operating an electrical or hydraulic plant, or does it purchase electricity on the market? Does it do its own legal work or procure legal services from an outside law firm? The aggregation of many thousands of decisions such as these, ranging from the large to the trivial, gives us a picture of both the size of the firm and the extent of its vertical integration into upstream or downstream areas. The firm’s “boundaries” are located at the precise point where the marginal cost of inside production and outside procurement are in equipoise.

The genius of state corporate law—especially Delaware General Corporation Law (Del. Gen. Corp. L.), the corporate law that governs the majority of publicly traded U.S. corporations—is that it recognizes the need for the law to facilitate a public company’s transition to becoming and maintaining itself as a very large organization in terms of both employment and investment. This allows an organization to implement its marginal analysis.

How corporate law facilitates a company’s marginal analysis and the resulting potential for a corporation to become very large in size astonishes both in terms of its simplicity and the relatively small number of brilliant insights required. First, it provides prospective equity investors with limited liability in their equity investments, thus encouraging the largest possible investment by any prospective shareholder. Second, by separating corporate governance from shareholder ownership, it allows the largest potential pool of investors to consider investing in the corporation. Third, as a result of this separation of governance from share ownership, it allows the hiring of the best managers unconstrained by share ownership to make the Coasean decisions that could lead a corporation to become very large in size. Fourth, corporate law’s default rules

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62. *Id.* at 71.
63. *See supra* note 40 and accompanying text (stating the percentage of U.S. publicly traded companies in Delaware). This law was written long before Professor Ronald Coase wrote *The Nature of the Firm*, *See Coase, supra* note 60.
64. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 44 (1991) (“The increased availability of funds for projects with positive net values is the real benefit of limited liability.”)
65. The value of such specialization of function is quite clear. The best managers can be selected without regard to their ability to finance the company. On the other end of the spectrum, the shareholder pool is greatly
grant “management a staggering degree of power.” For example, to facilitate Coasean decision-making, Del. Gen. Corp. L. provides that the board of directors does not have to seek approval from its shareholders if the board decides to acquire another company, as long as the board does not dilute existing shareholders by more than 20% or the board pays for the acquisition in cash. But more importantly, corporate law provides the board of directors and its executive management with the authority to make the major corporate decisions. Del. Gen. Corp. L. Section 141(a) provides that “[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.” Del. Gen. Corp. L. Section 142(a) provides that “[e]very corporation organized under this chapter shall have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board of directors which is not inconsistent with the bylaws . . . .” Moreover, corporate law protects the decisions of centralized authority from shareholder challenge by applying the business judgment rule to honest mistakes in business judgment, no matter how harmful the outcome to the company, and allowing for exculpation clauses which essentially eliminates all duty of care liability. As discussed below, this centralization of authority and its protection from shareholder challenge is critical for efficient decision-making in a large public company, not just in terms of Coasean decisions, but also in regard to all other significant decisions, such as appointing the corporation’s chief executive officer or approving the corporation’s entrance into new product and/or service areas, while the rationale for why corporate law defaults to protecting managerial discretion allows for an analysis of whether the authority for the nomination of directors should be given to shareholders.

Facilitating the ability of corporations to become very large in terms of both employment and investment is consistent with the notion that corporate law is meant to provide efficient default rules that reduce contracting costs for entering into business relations and the resulting benefits in terms of “capital formation, efficient capital

increased as shareholders do not have to bring decision making expertise along with their equity capital. See Frank H. Easterbrook & Daniel R. Fischel, Close Corporations and Agency Costs, 38 STAN. L. REV. 271, 301 (1986) (discussing different organizational structures).

66. This large concentration of corporate authority was first identified by Professor Adolph Berle and Dr. Gardiner Means writing just after the 1927 and 1929 amendments to the Del. Gen. Corp. L. See A.A. Berle, Jr. & Gardiner C. Means, Corporations and the Public Investor, 20 AM. ECON. REV. 54, 60 (1930).
68. Id. § 141(a).
69. Id. § 142(a).
70. According to the Delaware Supreme Court:

Our law presumes that “in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.” These presumptions can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith. If that is shown, the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders.

In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 52 (Del. 2006) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).
allocation, and savings and investment.”

However, the overlaying of facilitating bigness to the contractual nature of corporate law helps to explain why corporate law’s default rules are so geared toward the efficient management of large companies, allowing one to understand why the largest companies, General Motors, Exxon-Mobil, Hewlett-Packard, IBM, Walmart, etc. have taken on the corporate form.

A. Corporate Law and Centralized Management

According to Professor Robert Clark, “the single most important fact of corporate law is that managerial power is legally centralized.”

Corporate law promotes centralized management because it recognizes that a centralized, hierarchical authority is necessary for the successful management of a large corporation. To facilitate a centralized, hierarchical management structure, a public company’s board is provided the exclusive authority to manage and execute the various forms of explicit and implicit contracts that encompass a firm’s contractual make-up. However, board involvement in day-to-day operations is not necessary as statutory law allows the board to delegate its authority to executive management. This decentralization frees up many board members from having to participate in the management of the firm, but at the same time consolidates power at the top of a corporation’s hierarchy—the board and executive management—without providing shareholders a role in the decision-making mix. As a result, there is a significant imbalance between the authority of the board and executive management compared to the accountability that shareholders can provide.

Examples of this imbalance are easily observed. For example, the corporation’s board of directors, not its shareholders, control corporate assets; it is the board that


73. ROBERT C. CLARK, CORPORATE LAW 21 (1986).
74. DEL. CODE ANN. tit. 8, § 141(a).
75. Id. § 142(a).
76. Christopher M. Bruner, Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate, 36 DEL. J. CORP. L. 1, 3 (2011). Demonstrating the insignificant role shareholders played in corporate management, Professor Christopher Bruner has pointed out that “enacting, amending, and repealing bylaws are essentially the only corporate governance actions that shareholders can undertake unilaterally.” Id. Of course, the management of a public company still gets the advantage of excluding a number of proposals from its proxy materials under the SEC’s Rule 14a-8(i). See 17 C.F.R. § 240.14a-8 (2011) (explaining when a company must include a proposal in its proxy materials).
decides if the corporation will pay a dividend; the board is not required to follow the commands of its shareholders, even if shareholders pass a unanimous resolution requesting the board to act in a specific manner; shareholders may ratify a board’s action, but the board must first approve the action; the business judgment rule protects from liability the decisions of independent and disinterested boards even when their decisions have disastrous outcomes; and shareholders are required to make demand before filing a derivative suit or demonstrating demand futility.

B. The Value of Centralized Authority

To explain the minimal involvement of shareholders in the decision-making process, Professors Michael P. Dooley and Stephen M. Bainbridge argue that corporate law must protect board authority to maximize economic efficiency. They base their argument on Kenneth Arrow’s theory that centralized authority in a large organization is the most efficient for the management and analysis of information.

Arrow’s [theory] starts out with the basic proposition that “authority is needed to achieve a coordination of the activities of the members of the organization.” But, more importantly, centralized authority enhances organizational efficiency. According to Arrow, efficiency is created in a large organization because “the centralization of decision-making serves to economize on the transmission and handling of information.” Arrow’s theory on how centralized authority creates value is based on four propositions:

(1) Since the activities of individuals interact with each other, being sometimes substitutes, sometimes complements, and frequently compete for limited resources, joint decision on the choice of individuals’ activities will be superior to separate decisions.

(2) The optimum joint decision depends on information which is dispersed
among the individuals in the society.

(3) Since transmission of information is costly, in the sense of using resources, especially the time of the individuals, it is cheaper and more efficient to transmit all the pieces of information once to a central place than to disseminate each of them to everyone.

(4) For the same reasons of efficiency, it may be cheaper for a central individual or office to make the collective decision and transmit it rather than retransmit all the information on which the decision is based.

For an organization to be successful in its decision making, its decisions must be based on adequate information and made in a timely manner. This requires the organization “to facilitate the flow of information to the greatest extent possible.” Such facilitation requires “the reduction of the volume of information while preserving as much of its value as possible.” Centralized authority allows for “superior efficiency” by minimizing the number of communication channels required in a large organization.84

In the context of corporations, the value of centralized authority provides extra benefits to widely held public companies. According to Professor Dooley, the value of centralized authority in an organization is magnified as the knowledge and interests of its members diverge.85 In a public company, information and interests differ between management and shareholders.86 Especially where there are a large number of shareholders, it is much more efficient for the board of directors and executive management, the corporate actors that possess an overwhelming information advantage, to make corporate decisions rather than shareholders.87

The value of authority in corporate governance, as represented by the decision-making authority of the board and executive management, arguably creates a default position under corporate law that the “preservation of managerial discretion should always be the null hypothesis.”88 As such, some have used it to defend board use of poison pills,89 even though it reduces the disciplinary effect on corporate management by

85. Dooley, supra note 4, at 467 (“Where the residual claimants are not expected to run the firm and especially when they are many in number (thus increasing disparities in information and interests), their function becomes specialized to risk-bearing, thereby creating both the opportunity and necessity for managerial specialists.”).
86. Id. at 466–67. The value of centralized authority is not as great in general partnerships and closely-held corporations because the same persons perform both the managerial and risk-taking (investment) functions. Management and partners or shareholders are essentially one and the same. Id.
87. Id.
protecting them from hostile takeovers.\footnote{Id. at 821–28. For a beautifully written argument explaining why hostile takeovers are necessary for corporate governance, see Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. POL. ECON. 110, 113 (1965) (“Only the take-over scheme provides some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders. Compared to this mechanism, the efforts of the SEC and the courts to protect shareholders through the development of a fiduciary duty concept and the shareholder’s derivative suit seem small indeed.”).}

However, the default position of protecting managerial discretion can be overcome if it can be shown that a corporate governance modification, such as proxy access, has greater value as a tool of accountability than the loss in value caused by a reduction in board and executive management authority.\footnote{Bainbridge, The Business Judgment Rule as Abstention Doctrine, supra note 82, at 108–09 (“In some cases, accountability concerns become so pronounced that they trump the general need for deference to the board’s authority.”).}

\section*{C. The Value of Accountability}

Although the value of centralized authority is dominant in corporate governance, it does not follow that the corporate board and its executives should be allowed to wield its authority without any accountability to shareholders\footnote{Bainbridge, The Board of Directors as Nexus of Contracts, supra note 82, at 6–7.} or other stakeholders who make significant firm-specific investments.\footnote{Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 VA. L. REV. 247, 249–54 (1999).} From the perspective of A.A. Berle, Jr. and Gardiner C. Means, the success of corporate law in helping to create large for-profit organizations was also a cause for alarm because it concentrated economic power in the hands of a limited number of institutions and created the potential for opportunistic behavior by corporate management.\footnote{Berle & Means, supra note 66, at 55–61. Interestingly, they note that the 1927 and 1929 amendments to the Del. Gen. Corp. L. were essentially written by New York law firms whose clients included large banking houses and large corporate clients. Id. at 59.} Therefore, the law and shareholders need to hold management accountable for its decisions otherwise it may act irresponsibly with the “likelihood of unnecessary error.”\footnote{ARROW, supra note 83, at 73–74.}

Arrow discussed accountability in terms of ensuring that authority in large organizations did not fall victim to information overload and the limitations of its decision-making capacity.\footnote{Id. at 74.} According to Arrow, “others in the organization may have access to superior information on at least some matters,”\footnote{Id. at 75.} Therefore, it is legitimate to criticize such authority and put into place some sort of “corrective mechanism.”\footnote{Id.}

An increase in the application of tools of accountability does not necessarily result in enhanced corporate decision making. The fear is that in the process of trying to correct errors resulting from irresponsible decisions, “the genuine values of authority” will be destroyed.\footnote{Id.} Such “a sufficiently strict and continuous organ of responsibility can easily
amount to a denial of authority.” Arrow suggests, “if every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.” For example, in a world without the business judgment rule, allowing all corporate business decisions that turn out badly to be reviewed by the courts on grounds of negligence and in turn inhibiting the ability of corporate managers to make decisions.

In terms of proxy access, Arrow’s approach to efficient decision making requires a determination of how efficient it is to shift the locus of decision making for the nomination of directors from the board to shareholders. At this point in the analysis, it does not appear very efficient. The board nominating committee has an informational advantage over even the most informed shareholders because of the inside information it has on how the current board interacts with each other and executive officers, expectations on how a particular nominee will meld with other board members and executive officers, and the needs of the corporation in terms of directors, based on both public and confidential information. Shareholders who want to take advantage of proxy access do not have this information available to them. Moreover, as discussed below, not all shareholders are informed about the company and those who do decide to participate in proxy access may have little information on the proper choice of director nominees.

D. Proxy Access May be Utilized by Uninformed Investors

It can be conceded that it is not empirically known how much in the way of informational asymmetries exists between management and shareholders at any firm at any point in time. It may be a little, it may be a lot, it just is not known. However, it is beyond doubt that information asymmetries do exist and that shareholders are at an informational disadvantage in nominating directors relative to directors.

But what has been described above is only part of the informational asymmetry story. Proxy access rules or proposals can also exacerbate the informational disadvantages of shareholders if it does not try to ensure that proxy access is limited to only those shareholders that have an adequate level of information to make an informed decision. This point becomes apparent when a public company’s stockholders are placed into groups based on the roles they play in the equity markets. These groups include insiders, liquidity traders, noise traders, market makers, and information traders.

Insiders are stockholders, such as board of directors and executive management, who have access to nonpublic information about the firm, but have significant restrictions

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100. Arrow, supra note 83, at 78 (emphasis added).
101. Id.
104. Id.
105. Id.
106. Zohar Goshen & Gideon Parchomovsky, The Essential Role of Securities Regulation, 55 DUKE L.J. 711, 722 (2006). This approach focuses on shareholders as having different functions in the equity markets versus having heterogeneous interests in the holding of company stock and the effects on corporate governance. For the later approach, see Rose, supra note 21.
in the trading of that information for profit.\textsuperscript{107} 

\textit{Liquidity traders} do not collect and evaluate information; rather they participate in the market depending on their funding needs.\textsuperscript{108} These are your passive, index fund investors.\textsuperscript{109} 

\textit{Noise traders} are irrational investors and utilize diverse investment strategies.\textsuperscript{110} A major problem with noise traders is that it is hard to differentiate them from information traders.\textsuperscript{111} Some noise traders may invest based on fads and rumors while others simulate information traders but in a less efficient manner as they rely on old information or are simply slower in analyzing information that is publicly available.\textsuperscript{112} 

\textit{Market makers} are professionals who facilitate trading and maintain a market for securities by offering to buy or sell securities on a regular basis.\textsuperscript{113} Market makers are well informed about the demand and supply of a security but they are not as well informed as information traders regarding firm-specific information.\textsuperscript{114} 

\textit{Information traders} are those market participants who trade in the financial markets based on recommendations and advice and those who provide such recommendations and advice.\textsuperscript{115} These traders “are willing and able to devote resources to gathering and analyzing information as a basis for their investment decisions.”\textsuperscript{116} Information traders include sophisticated professional investors such as activist hedge fund managers, money managers, and other market professionals.\textsuperscript{117} Analysts who do not trade for their own account are still considered information traders (indirect traders) because they provide valuations and recommendations to their clients who will then utilize this information for their own trading purposes.\textsuperscript{118} Information traders look for differences between value and price based on the information they possess and “then trade to capture the value of their informational advantage.”\textsuperscript{119} Information traders move security prices toward their fundamental values and are in essence “the agents who render markets efficient.”\textsuperscript{120} 

The value of information traders in the pricing of securities was first pointed out by Professors Sanford J. Grossman and Joseph E. Stiglitz.\textsuperscript{121} They noted that it is not possible for securities markets to operate without market participants investing in information and earning positive returns for their efforts. They argued that “because information is costly, prices cannot perfectly reflect the information which is available, since if it did, those who spent resources to obtain it would receive no compensation”;\textsuperscript{122}
If competitive equilibrium is defined as a situation in which prices are such that all arbitrage profits are eliminated, is it possible that a competitive economy always be in equilibrium? Clearly not, for then those who arbitrage make no (private) return from their (privately) costly activity. Hence the assumptions that all markets, including that for information, are always in equilibrium and always perfectly arbitrated are inconsistent when arbitrage is costly.

We propose here a model in which there is an equilibrium degree of disequilibrium: prices reflect the information of informed individuals (arbitrageurs) but only partially, so that those who expend resources to obtain information do receive compensation.\(^{123}\)

The insight provided by Professors Grossman and Stiglitz adds refinement to what is meant by an efficient stock market. The efficient market hypothesis “states that in free and actively traded markets, stock prices will fully reflect all available information about the corporation.”\(^{124}\) This understanding of equity markets has come to mean that information traders such as security analysts add little value in the pricing of publicly-traded securities.\(^{125}\) Instead, we should understand that information traders play a vital role in incorporating costly information into stock prices.\(^{126}\)

For example, think of the recent epidemic of Chinese companies that have been allowed to trade on U.S. stock exchanges with inflated reported revenues and profits.\(^{127}\) These misrepresentations would not have come to light without the research of information traders into the operations of these companies.\(^{128}\) Their research is costly, for example, hiring investigators to go out into the field and visit the operations of the targeted Chinese firms, but has allowed those information traders who have made the effort to earn handsome rewards by short-selling the stock of those they have found to be

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\(^{123}\) Id. at 393.


\(^{126}\) According to Professors Grossman and Stiglitz:

Efficient Markets theorists seem to be aware that costless information is a sufficient condition for prices to fully reflect all available information . . . ; they are not aware that it is a necessary condition. But this is a reductio ad absurdum, since price systems and competitive markets are important only when information is costly.


\(^{127}\) Steven Mufson, Gaining by Betting Against Flimsy Chinese Firms, WASH. POST, Aug. 28, 2011, http://www.washingtonpost.com/business/gaining-by-betting-against-flimsy-chinese-firms/2011/08/20/gIQAe4KFgl_story_1.html. Since 2004, more than 300 Chinese companies have accessed U.S. capital markets through reverse mergers. Id. Access begins with a Chinese company swapping its shares with the shares of a U.S.-listed company that is more or less defunct. Id. Then, the U.S.-listed company goes through a makeover by taking on a new name, directors, and then reports excellent results from its new overseas operations. Id. Such a makeover allows the U.S.-listed company to potentially raise millions of dollars by issuing additional stock to investors in the U.S. stock market. Id.

\(^{128}\) Mufson, supra note 127.
misrepresenting their results.\textsuperscript{129} As a result, the prices of these stocks trade closer to their fundamental values.

Finally, think of an equity market where there are no information traders, only liquidity traders.\textsuperscript{130} Such a market would be characterized by general price shifts affecting all passively managed funds, including indexed stocks, as the liquidity needs of these investors shift over time.\textsuperscript{131} However, such a market would not be able to price securities close to their fundamental values as liquidity traders buy and sell securities regardless of new information, making their trades random relative to new information entering the market.\textsuperscript{132} Thus, without market participants such as information traders, there would be no mechanism in place to allow a market to efficiently price securities.

Outside of insiders, who nominate directors as members of the board, information traders, who gather and analyze information on the companies they invest in, are in the best position to participate in proxy access. On the other hand, noise traders who trade based on fads or past price movements, liquidity traders who invest in indexed funds or investment portfolios that primarily utilize passive investment strategies, and market makers in company stock do not devote resources to the gathering and analyzing of company information in their investment decisions. Therefore, for purposes of proxy access, information traders are the only investors who possess the information to make an informed judgment on which candidates to nominate for seats on the board.

However, given most shareholders’ natural lack of interest in the corporate governance of those many companies they invest in, including many information traders whose primary function is to value not govern the companies they invest in—after all, the beauty of a public corporation is that it allows investors to specialize in investing and management to specialize in management without having to provide capital\textsuperscript{133}—it is not hard to foresee that those investors who are most eager to participate in proxy access are those who may have significant conflicts of interest, such as unionized employees,\textsuperscript{134} who see proxy access as a means to receive a little extra of the corporate pie; politically motivated managers of public pension funds who utilize corporate governance advocacy as a means to enhance their political ambitions;\textsuperscript{135} corporate governance gadflies who

\begin{footnotes}
\item \textsuperscript{129} Id.
\item \textsuperscript{130} Jill E. Fisch, \textit{Confronting the Circularity Problem In Private Securities Litigation}, 2009 Wis. L. REV. 333, 346 (2009). According to Professor Jill Fisch, “Passive diversified investing may be a rational strategy for a particular investor, but this strategy is devastating for the market as a whole.” \textit{Id.}
\item \textsuperscript{131} Goshen & Parchomovsky, supra note 106, at 726.
\item \textsuperscript{132} \textit{Id.} at 729.
\item \textsuperscript{133} See Easterbrook & Fischel, supra note 65, at 301 (describing the increase in shareholder pool when shareholders are not required to bring decision-making expertise along with their equity capital).
\item \textsuperscript{134} The following excerpt from Roberto Romano’s article on shareholder activism would appear to describe the benefits that union and pension fund shareholders can reap from proxy access:

Examples of potential benefits which would be disproportionately of interest to proposal sponsors are progress on labor rights desired by union fund managers and enhanced political reputations for public pension fund managers, as well as advancements in personal employment, the “revolving door” issue for government employees, whose salaries are considerably lower than the private sector.

\item \textsuperscript{135} Id.
\end{footnotes}
have as their goal an increase in shareholder voting power,\textsuperscript{136} or those investors who want to advance their own moral or socially responsible agenda\textsuperscript{137} As discussed below, providing proxy access to such investors may reduce the ability of the board of directors and executive management to achieve the corporate objective.

\textbf{E. Shifting the Locus of Agency Costs}

In the corporate context, because of the separation between ownership and control, we are most concerned that “unaccountable authority may be exercised opportunistically.”\textsuperscript{138} Opportunistic behavior includes not only corporate decisions that result from the decision-making limitations of corporate authority, as Arrow discussed, but also when corporate management shirks its duties or tries to extract private benefits from the corporation.\textsuperscript{139} These later types of behavior can be understood as forming the classic agency cost problem in public companies.\textsuperscript{140} Examples of tools of accountability used to combat agency costs include the fiduciary duties of care and loyalty, the enforcement of fiduciary duties through shareholder class action and derivative lawsuits, required shareholder approval of major corporate actions, a shareholder’s right to inspect a corporation’s books and records for a proper purpose, required shareholder approval for changes to the articles of incorporation, the power of shareholders to unilaterally propose and adopt bylaws, proxy contests, and director independence requirements for companies listed on U.S. stock exchanges.

From the shareholders’ perspective, tools of accountability are meant to keep the board and executive management focused on the corporate objective. As understood in the context of the firm as a nexus of contracts,\textsuperscript{141} shareholder wealth maximization is the

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\item \textsuperscript{136} James R. Copeland, Proxy Monitor 2011: A Report on Corporate Governance and Shareholder Activism (Sept. 2011), available at http://proxymonitor.org/Reports/Proxy_Monitor_2011.pdf (finding that the majority of shareholder proposals at Fortune 150 companies are put forth by corporate gadflies, labor unions, and social investment vehicles affiliated with religious organizations or public policy groups).
\item \textsuperscript{137} Id. See also Kevin Roose, Nuns Who Won’t Stop Nudging, N.Y. Times, Nov. 13, 2011, at B1 (citing the Sisters of St. Francis of Philadelphia as leading shareholder activists).
\item \textsuperscript{138} Bainbridge, The Business Judgment Rule as Abstention Doctrine, supra note 82, at 107.
\item \textsuperscript{139} Dooley, supra note 4, at 465. According to Professor Dooley, “Although opportunism is often equated with ‘cheating,’ for present purposes it will be useful to think of opportunism as embracing all failures to keep previous commitments, whether such failures result from culpable cheating, negligence, ‘understandable’ oversight, or plain incapacity.” Id.
\item \textsuperscript{140} Rose, supra note 21, at 1361 (citing Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. Fin. Econ. 305 (1976)). As explained by Professor Rose:

Under a classic theory of the firm, agency costs in the corporate context increase as ownership is separated from control. As the manager’s ownership of shares in the firm decreases as a percentage of the total, the manager will bear a diminishing fraction of the costs of any nonpecuniary benefits he takes out in maximizing his own utility. To prevent the manager from maximizing his utility at the expense of the shareholders, shareholders will seek to constrain the manager’s behavior by aligning the manager’s interests with the shareholders’ interests.

\textit{Id.} at 1361 (citations omitted).
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corporate objective when it is assumed that all of the corporation’s contracts are complete except for the firm’s contract with shareholders.\textsuperscript{142} Complete contracts “specify all the future payoff-relevant contingencies.”\textsuperscript{143} Therefore, those who enter into complete contracts would be “contractually protected against any negative consequence.”\textsuperscript{144} However, the contract with shareholders is anything but complete. Shareholders part with their money in exchange for the expectation of future returns, but without any guaranteed returns.

In a world where all parties are protected by contract except for shareholders, shareholders are truly the sole residual claimants to the net cash flows of the firm. As residual claimants, shareholders take on the residual risk, i.e., “the risk of the difference between stochastic inflows of resources and promised payments to agents,” and in exchange receive the right to receive the net cash flows of the corporation.\textsuperscript{145} Since shareholders bear risks from discretionary decisions the corporation made, shareholders would require shareholder wealth maximization as part of the hypothetical bargain with the firm’s other parties.\textsuperscript{146} This would mean that the firm should implement all major decisions such as compensation policy, new investments, dividend policy, strategic direction, and corporate strategy based on the best interests of shareholders.\textsuperscript{147}

However, contracts are never really complete with non-shareholder parties. It is just too costly when writing up a contract to specify all the future payoff-relevant contingencies.\textsuperscript{148} But even if the firm cannot make the contracts complete, most corporate law contractarians would still argue that shareholder wealth maximization must be the default rule because the gaps in the shareholder contract are significantly greater than found in the contracts of other parties contracting with the firm.\textsuperscript{149}

\begin{thebibliography}{99}
\bibitem{142} Margaret M. Blair, Ownership and Control 230 (1995).
\bibitem{143} Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301, 311 (1983).
\bibitem{144} Luigi Zingales, In Search of New Foundations, 55 J. Fin. 1623, 1632 (2000).
\bibitem{145} Fama & Jensen, supra note 143, at 302.
\bibitem{146} Easterbrook & Fischel, supra note 64, at 67–68.
\bibitem{147} Macey, supra note 141, at 7.
\bibitem{149} Id. Alternatively, Professors Margaret Blair and Lynn Stout have argued that shareholder wealth maximization is not the corporate objective when other stakeholders make firm-specific investments in the firm. Bernard S. Sharfman, How the Strong Negotiating Position of Wall Street Employees Impacts the Corporate Governance of Financial Firms, 5 Va. L. & Bus. Rev. 349, 356–57 (2011) (citing Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247, 249 (1999)). Firm-specific investments are “irrevocable commitment(s) of resources to the joint enterprise,” and can be made by various stakeholders including executives, employees, researchers, creditors, the local community and marketers, among others. Id. Stakeholders are willing to make firm specific investments because they give rise to implicit contracts that provide them with residual claims on the net cash flows of the corporation, just like the residual claims held by shareholders. Id. The board must honor these implicit contracts or else face a reduced investment or disinvestment in the corporation by those stakeholders who allow the company to prosper. Id. When this occurs, shareholder wealth maximization is no longer the corporate objective, requiring the board to act as a mediating hierarchy such that it must balance the interests of all stakeholders who make firm-specific investments, not just shareholders. Id.

It is beyond the scope of this Article to provide a detailed analysis of the implications for corporate law created by Professors Blair and Stout’s model of corporate governance. However, there are several implications that should be kept in mind. First, the default rules under corporate law only provide shareholders
Even if proxy access cannot be justified based on the argument that it moves decision-making to a location in the corporation that is better informed, it still may be justified as a tool of accountability based on its ability to significantly reduce agency costs. However, it is doubtful that proxy access can provide those benefits as its effect would be to shift the locus of agency costs in the director–nominee selection process from a board that is made up of a majority of independent directors and a nominating committee made up exclusively of independent directors—a composition requirement which should in itself significantly mitigate agency costs in the nomination process—to those shareholders who may take advantage of proxy access to “use their position to self-deal—i.e., to take a non-pro rata share of the firm’s assets and earnings—or to otherwise reap private benefits not shared with other investors.”

For example, Professor Joseph Grundfest points out that proxy access may generate at certain firms significant “megaphone externalities” in the form of the ability of shareholders to draw attention to their own special causes—such as union and public pension fund issues—even if their nominees have no chance of winning an election. These megaphone externalities may promote objectives that the majority of shareholders do not consider to be in the best interests of the corporation. As a result, the corporation provides certain shareholders “electoral leverage” they can use in negotiating with the board to extract concessions for whatever they are trying to accomplish, whether or not their objective is to maximize shareholder wealth.

Moreover, proxy access allows shareholders to participate in corporate decision-making without any accountability. Unlike directors, shareholders do not have to take into consideration any type of fiduciary duties when availing themselves of proxy access, and thus encouraging opportunistic behavior. If so, then perhaps fiduciary duties should apply to shareholders who take advantage of proxy access? Professors Iman Anabtawi and Lynn Stout argue that, in this era of shareholder empowerment where more and more corporate decision-making is being moved from the board to activist shareholders, fiduciary duties should apply to activist minority shareholders, similar to controlling shareholders, when they pressure the board and corporate officers to take actions that are in their own self-interest, either in the context of a business decision or a corporate transaction. However, this idea does not appear workable in the context of proxy

with the right to enforce their interests. Other stakeholders who make firm-specific investments must trust the board and executive management to consider their interests. Corporate law supports this approach by protecting directors and executive management from liability when their decisions appear to favor non-shareholder stakeholders who make firm-specific investments. Second, Blair and Stout’s model puts into focus the complexity of corporate governance and why the decisions made by a centralized authority need to be respected and valued.


151. Grundfest, supra note 8, at 378.

152. Id.

153. Id. at 382.

154. Professor Roberta Karmel, former SEC Commissioner, was the first to suggest the idea of fiduciary duties for those shareholders who take advantage of proxy access. Roberta S. Karmel, Should a Duty to the Corporation Be Imposed on Institutional Shareholders?: 60 BUS. LAW. 1, 20–21 (2004).

155. Anabtawi & Stout, supra note 17, at 1295. According to Professors Anabtawi and Stout:
access. For example, the duty of loyalty would be difficult to enforce as there is no particular business decision or transaction involved that would directly implicate a shareholder’s economic self-interest, even though it may be clear that the shareholder who is utilizing proxy access is not acting in the best interests of the corporation or the majority of shareholders. More specifically, how would fiduciary duties be applied when the head of a public pension fund with political ambitions utilizes proxy access to enhance his corporate governance credentials or when a union pension fund utilizes proxy access in order to gain a negotiating advantage with the company for its union members?156

In sum, proxy access is an inefficient tool of accountability, creating the expectation that its use will reduce shareholder wealth, not increase it. The responsibility for director nominations is being shifted from the corporate apparatus that has the greatest informational advantage in understanding the needs of the corporation, the board of directors, to certain shareholders who do not possess such an advantage and indeed may have little information in that regard. Moreover, proxy access will most likely relocate, not reduce agency costs as it will allow certain shareholders, such as unionized employees and their pension funds and public pension funds, to participate in corporate decision-making without regard for fiduciary duties, opening up the potential for opportunistic behavior on their part.

IV. IN THE EVENT

In the event the arguments this Article made do not win the day and shareholders approve a proposal on proxy access at a particular company or the SEC insists on taking another crack at mandatory proxy access, this author hopes that the parameters of proxy access will be structured to favor information traders or at least not discriminate against them. For the reasons stated above, information traders possess the knowledge about the

[W]e propose that all shareholders, like all directors and officers, be viewed as owing latent duties to the firm and their fellow shareholders. These latent duties would be triggered whenever a particular shareholder—whether or not it is technically a shareholder capable of controlling the boards’ decisions as to all matters—in fact manages to successfully influence the company’s actions with regard to a particular issue in which that shareholder has a material, personal economic interest . . . .

[Moreover,] shareholder fiduciary duties would not, as it is now, be triggered by a particular shareholder’s ability to direct corporate decision-making in the abstract, but rather by that shareholder’s ability to influence the outcome of a particular corporate decision in which it has a personal conflict of interest. This change in level of analysis—from the general corporate level to the level of a discrete issue—defines the idea of ‘control’ more expansively to account for the reality that modern shareholders can influence corporate policy through a variety of strategies that do not require them to control a numerical majority of the firm’s voting shares. Thus, we would say that a shareholder ‘controls’ corporate conduct whenever its action is a determinative, or ‘but for,’ cause of the particular corporate decision in issue.

Id. (emphasis added) (citations omitted).

company that will allow them to make the best director nominations relative to other types of shareholders. However, this does not mean that proxy will not cause harm to corporate governance—it will—but at least the damage can be minimized to some extent.

Not discriminating against information traders means doing away with the three-year holding period requirement such as found in Rule 14a-11.\textsuperscript{157} It is hard to understand the logic in having a three-year holding period that favors passive investors such as liquidity traders over information traders. For example, what makes investors who have held large amounts of company stock for 10, 20, or 30 years in portfolios using passive strategies, and therefore do not analyze information about the company targeted for proxy access, more qualified to utilize proxy access than investors who have held company stock for six months but made their decision to invest based on fundamental analysis?

Moreover, the three-year holding period will have a detrimental effect on activist hedge funds, those investors who “concentrate on fundamental analysis and so pick their targets on a fuller informational basis than customarily is the case with institutional equity investors,”\textsuperscript{158} and who have the ability and desire to buy three percent or more of company stock, but cannot meet the three-year holding requirement.\textsuperscript{159} These are the investors that will help mitigate the harm done by proxy access and, therefore, not the ones you want to exclude from the process.

The SEC based its decision on its “belief that holding securities for at least a three-year period better demonstrates a shareholder’s long-term commitment and interest in the company.”\textsuperscript{160} Contrary to the SEC’s assertion that the three-year holding period will limit proxy access to shareholders with a long-term perspective,\textsuperscript{161} there is no empirical evidence to support this claim.\textsuperscript{162} Moreover, and perhaps more importantly, they acknowledged that they simply succumbed to the interests of those who commented on the proposed rules.\textsuperscript{163} Hopefully, the next time around, if there is one, they will not succumb to such interests.

Alternatively, companies can be proactive and try to minimize the damage done by proxy access. For example, Professor J.W. Verret recommends that public companies revise their bylaws regarding director qualifications such that it would be difficult for a shareholder to nominate a director that does not have the skills and experience that the board would find satisfactory.\textsuperscript{164} Moreover, these bylaws could require that a director hold an MBA degree, have obtained the title of Certified Financial Analyst, and have at

\textsuperscript{158} Bratton & Wachter, supra note 16, at 684.
\textsuperscript{159} Fisch, supra note 3, at 27. See also Marcel Kahan & Edward B. Rock, The Insignificance of Proxy Access, 97 Va. L. Rev. 1347, 1376 (2011) (predicting what type of shareholder will use proxy access rules).
\textsuperscript{161} Id.
\textsuperscript{162} Fisch, supra note 3, at 27–28.
\textsuperscript{163} Facilitating Shareholder Director Nominations, Exchange Act Release No. 34-62,764, 75 Fed. Reg. at 56,697–98 (“We also based our decision to have a holding period longer than one year on the strong support of a variety of commenters.”).
\textsuperscript{164} Verret, supra note 156, at 404.
V. CONCLUSION

In a Coasean world, one can understand the purpose of corporate law as facilitating the efficient management of large companies in terms of employment and investment. Any new tool of corporate accountability, whether the marketplace or operation of law created it, can also be justified on efficiency grounds. Given that centralized management is so highly valued in a large organization, this means that any new tool of accountability must provide enough value to overcome the default position that the “preservation of managerial discretion should always be the null hypothesis.”166 If the tool of accountability cannot be justified on efficiency grounds, then its justification must be based on public policy,167 perhaps as a means to reduce third-party effects. Unfortunately, proxy access cannot be justified on either basis.

Brett McDonnell argued that applying Arrow’s value of centralized authority approach to corporate law does not “tell us whether reform in favor of somewhat more accountability at the expense of some, but far from a total, loss in authority is a good idea or not.”168 However, at least in the case of proxy access, there is no uncertainty. Proxy access shifts the responsibility for director nominations from the corporate apparatus that has the greatest informational advantage in understanding the needs of the corporation: the board of directors, to certain shareholders who do not possess such an advantage and indeed may have little information in that regard. The result should be an increased likelihood of error in the director nomination process. Moreover, proxy access shifts the temptation to extract private benefits from the corporation, in the director nominee selection process, from the board of directors and its nominating committee, to certain shareholders who, unlike directors, are not subject to fiduciary duties.

For those concerned about the future of corporate governance, proxy access, as facilitated through the actions of the federal government, whether through amended Rule 14a-8(i)(8) or eventually through a mandatory proxy access rule, should be understood as part of a very disconcerting trend. This trend is the federally mandated implementation of shareholder empowerment, especially as it has been implemented over the years through the Basic v. Levinson169 decision, which affirmed the ability of the federal courts to abandon the requirement of direct reliance in securities fraud class actions,170 the
Sarbanes–Oxley Act,\textsuperscript{171} the Dodd–Frank Act,\textsuperscript{172} and SEC approved stock exchange rules.\textsuperscript{173} These laws have been extremely harmful to corporate governance, shifting the balance of authority toward shareholders and thereby threatening the value of centralized authority.

Even if we assume that the proponents of shareholders are pure in their intentions, federally mandated shareholder empowerment is an approach that is misguided. As Professors Edward B. Rock and Michael L. Wachter pointed out, corporate law is not all about minimizing agency costs.\textsuperscript{174} Such an approach utilizes an incomplete model of the firm, focusing on the costs centralized management created, but at the same time ignoring the value that it provides. In that context, federally facilitated proxy access becomes one more step on the road to severely restricting the genius of corporate law, allowing large organizations to operate efficiently in a Coasean world where significant transaction costs exist.

It is hoped that as a result of this Article’s discussion on the purpose of corporate law and the value of authority, shareholder activists will become less inclined to take the position that more tools of accountability will always lead to better corporate governance. On the contrary, it can be quite harmful. Shareholder activists need to gain the perspective that protecting the value of centralized authority is the most efficient means for maximizing shareholder wealth and that large public companies are economic, not

\textsuperscript{171} A. Booth, The End of Securities Fraud Class Action?, 29 REG. MAG. 46 (2006).

\textsuperscript{172} Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2000). The Dodd–Frank Act has several other significant corporate governance provisions besides proxy access. For example, Section 951 requires periodic shareholder advisory votes on executive compensation (say-on-pay), Section 952 requires that the compensation committees of a reporting company be composed of independent members, Section 953 directs the SEC to require public companies to provide additional disclosures with respect to executive compensation, Section 954 expands the ability of the SEC to clawback executive compensation, and Section 972 requires that companies disclose whether the same person holds both the CEO and Chairman of the Board positions and why they either do or do not do so. Id. §§ 951–954, 972.

\textsuperscript{173} Under Section 19(b)(1) of the Securities Exchange Act of 1934, stock exchanges, such as the NASDAQ and the NYSE, must gain SEC approval for rule changes prior to implementation. Securities Exchange Act of 1934 § 19(b)(1), 15 U.S.C. 78s(b)(1) (2006). A key focus of the major U.S. stock exchanges is to make sure that the board of a listed company is composed of a majority of independent directors. In general, independent directors can be defined as directors whose ties to the corporation are not so significant as to influence their judgment in corporate matters. The stock exchanges set out both subjective and objective tests for establishing director independence. See, e.g., NYSE, LISTED COMPANY MANUAL §§ 303A.02 (2010), available at http://nysem manual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4&manual=%2Fcm%2Fsections%2Fcm-sections%2F (explaining how the test for establishing director independence is a two part objective and subjective one). Moreover, the stock exchanges require a listed company to have a majority of independent directors and that the major corporate board committees—audit, compensation, and nominating—be composed entirely of independent members. See, e.g., id. §§ 303A.04–303A.06 (explaining the requirement for independent members).

\textsuperscript{174} Rock & Wachter, supra note 88, at 1622.
political.\textsuperscript{175} Institutions which first and foremost need to respond to the accountability provided “by the market for stock (and the managers’ need to raise capital), the market for goods, and the market for managers’ services.”\textsuperscript{176}

In the specific context of proxy access, shareholders need to realize that implementing proxy access at the company level can be harmful to corporate governance and that keeping the nomination of directors under the control of the board of directors and its nominating committee will maximize the wealth of shareholders. Moreover, it is time for the SEC to acknowledge that proxy access will have wealth reducing effects and that its best course of action is to end its proxy access initiative. This means that the SEC should reverse course and go back to the pre-amendment Rule 14a-8(i)(8) which allowed a public company to preclude shareholder proposals on proxy access from being included in its proxy materials. Moreover, the SEC should never again propose mandatory proxy access rules.
