February, 2004

Public Company Shareholders Acting as Owners: Three Reforms--Introducing the "Oversight Shareholder" (with E. Fogel & D. Addis)

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PUBLIC COMPANY SHAREHOLDERS ACTING AS OWNERS: THREE REFORMS—INTRODUCING THE "OVERSIGHT SHAREHOLDER"

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ABSTRACT

This article proposes the addition of three safe harbors to the securities laws that would allow public company shareholders who hold one percent or higher of company shares for six months or more to engage in oversight of the affairs of their company and probe without fear of incurring liability. The proposed safe harbors would in certain instances protect an oversight shareholder—(1) from being deemed to have illegally traded on inside information; (2) from having to go through the cumbersome and costly process of filing a proxy statement to communicate with fellow shareholders; and (3) from acquiring "controlling person" liability. These safe harbors will encourage the owners of public companies to maintain oversight of the affairs of their companies, which, in turn, will restore public confidence in the public securities market.

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I. INTRODUCTION

Most private corporations are run by and accountable to their owners. Today, however, investors in most large publicly traded companies do not run their companies but merely choose to "vote with their feet" and sell if they are dissatisfied with performance.[1] With the current securities regulatory scheme, shareholders (even large shareholders) of publicly traded corporations are loath to take action or make inquiries to avoid being exposed to three areas of potential liability; namely (1) insider trading liability,[2] (2) shareholder communication liability,[3] and (3) control person liability.[4] As a result, shareholders often become aware of serious management issues only after there is a publicly announced material adverse event.

This lack of management accountability to owners was likely the culprit that permitted the financial improprieties crises that have recently plagued our markets and brought on the financial collapse of large public companies, like Enron. While it is true that a company's management should have flexibility to make decisions in running a company without constant scrutiny from shareholders, the Enron crisis has demonstrated that an imbalance exists between management flexibility and investor/owner oversight.

The board of director governance structure is often ineffective and conflicted. Many board members are personally selected by a charismatic CEO or chairperson and these board members are loath to argue with or press management for fear of being asked to resign. Frequently, board

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[1]*See* Dan Ackman, *Walter Hewlett Makes His Case*, Apr. 26, 2002, *available at* http://www.forbes.com/2002/04/26/0426topnews_print.html (contrasting, in part, concepts of political democracy and corporate democracy in that investors in a corporation "quite properly," vote with their feet when they do not like what management is doing); Robert Parrino et al., *Voting with Their Feet—Institutional Investors and CEO Turnover*, Jan. 3, 2002, *available at* http://www.mccombs.utexas.edu/aimcenter/Working%20Papers/Parrino2.pdf (providing empirical evidence that institutional investors are more likely to "vote with their feet" and sell their investment rather than involve themselves in the affairs of management); Elizabeth Wine, *Rise of the Corporate Crusaders*, *available at* http://www.independentdirector.co.uk/news/rise_corporate.crusader,phphtml, originally published in *Financial Times* (London, England), Mar. 5, 2004 London Ed. 1 (proposing that the recent shareholder revolt against Michael Eisner at Disney may show a new trend that shareholders are becoming more active and less apt to vote with their feet when dissatisfied with management).

[2]Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2000); 17 C.F.R. § 240.10b-5 (2002).

[3]*See* Daniel M. Taitz & Lance J. Gotko, *Shareholder Communications*, *in* DOING DEALS—1997 UNDERSTANDING THE NUTS AND BOLTS OF TRANSACTIONAL PRACTICE 133, 138-39 (Prac. L. Inst. 1997) (explaining the extent of shareholder liability under § 14(a) of the Securities Exchange Act of 1934).

[4]*See* Securities Act of 1933, 15 U.S.C. § 77o (2000); Securities Exchange Act of 1934, § 78t(a).

members have strong reciprocal social or business ties, making the board seem more like a social club than a probing watchdog for shareholders. Anyone who has ever served on a public board knows this is true.

To combat these imbedded conflicts, Congress and the Bush Administration enacted the Sarbanes-Oxley Act of 2002 to restore investor confidence in public companies.[5] This recent legislation, however, was more of a quick reaction to a public policy crisis and creates administrative burdens without addressing the underlying problems. Owners still have statutory and case law impediments that dissuade them from acting like true owners. Placing more burdens and threats of penalties on management, the Sarbanes-Oxley Act of 2002 does nothing to foster the needed balance between management and owners. What is needed are changes to existing statutes and regulations, which will permit owners to have more direct oversight of the affairs and management of their companies.

In this article the authors offer a few suggestions for ways to permit a certain class of public company shareholders to act like owners. This class of public company shareholders would be limited to those who hold one percent or higher of the company's shares for six months or more ("oversight shareholders").[6] Section II of this article suggests reform of the insider trading laws to address an oversight shareholder's current fear of getting too involved in the affairs of public companies. Understandably, shareholders fear that by asking too many questions they will learn nonpublic information, which may block them from making trades in the company's stock that they would ordinarily make.[7] The proposed insider trading reform will take into account that oversight shareholders have the right to inquire as to a company's affairs without the threat of facing insider trading liability. The proposal creates a safe harbor for these oversight shareholders, allowing them to file "trading plans" to declare in advance their trading intentions. This will allow these investors to act more like owners and place a more meaningful check—indeed owner oversight—on management's decisions.

Section III of this article suggests reform of the shareholder communication laws to make it less cumbersome and less expensive for oversight shareholders to communicate with each other as owners, to discuss the problems facing their company, and to take action. For instance, a shareholder desiring to wage a proxy battle to vote out

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[5]*See* Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7201-7266 (2002).

[6]The oversight shareholder does not have to be a single shareholder or entity. The oversight shareholder could be a group of shareholders who collectively own one percent or more of the outstanding equity securities and who could function as an "oversight shareholder committee."

[7]*See infra* text accompanying note 12.

incumbent directors is allowed to "test the waters,"[8] but is not allowed to initiate wide scale owner communication without first filing a proxy statement,[9] which is burdensome and expensive. As a result, a shareholder is less likely to communicate with fellow shareholders on important company matters because the costs and burdens are too high or for fear of running afoul of the proxy rules. The proposal is to provide oversight shareholders with a safe harbor to communicate with fellow oversight shareholders about company matters, which, in this age of electronic and internet communication, is economically and practically feasible.[10]

Section IV of this article suggests reform to the "controlling person" status laws to address the oversight shareholder's understandable reluctance to get too involved in the managerial affairs of their companies for fear of acquiring "controlling person" status.[11] This fear of getting too involved frequently occurs when a company's financial fortunes are going "south," which is exactly the time when there should be more owner scrutiny of management. The suggestion presented is to enact certain legislation that would insulate oversight shareholders from liability for suggesting or insisting on management, compensation or policy changes, so long as it otherwise does not benefit them personally.

These reforms are not intended to change the face of the securities

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[8]*See generally* 17 C.F.R. §§ 240.14a-2(b)(2), 240.14a-12 (2002) (exempting certain communications from Rule 14a-3 proxy statement requirements).

[9]*See* Taitz & Gotko, *supra* note 3, at 143-44.

[10]In fact, in 2003 the Securities and Exchange Commission (SEC) proposed a rule that would allow a certain class of shareholders to nominate directors on a public company's annual proxy statement. *See* Proposed Rule—Security Holder Director Nominations, Exchange Act Release No. 34-48626 (Oct. 14, 2003), *available at* http://www.sec.gov/rules/proposed/34-48626.htm. A public company would become subject to the rule upon the occurrence of either one of the following "triggering" events—if, at an annual meeting of shareholders taking place after January 1, 2004, (a) a director nominated on a company's proxy statement received more than thirty-five percent of "withhold" votes of all the votes cast (with certain exceptions), or (b) a shareholder proposal to adopt the new rule is put forth by a shareholder or group of shareholders owning in the aggregate more than one percent of the company's securities entitled to vote and who have held such securities for at least one year, and such proposal receives more than fifty percent of votes in favor. *Id.* Once the company becomes subject to the new rule, the rule will remain in effect for approximately two years (i.e., the following two annual meetings of shareholders). To take advantage of having a nominee placed on the company's proxy (after the company becomes subject to the new rule), shareholders or a group of shareholders would have to (among other requirements) own in the aggregate more than five percent of the company's voting securities that are entitled to vote on the election of directors for at least two years prior to putting forth such a nominee on the company's proxy statement. *Id.* The reform to the shareholder communications/proxy rules suggested in this article dovetail with and compliment the new rule proposed by the SEC. Although the reforms suggested in this article are broader and affect more than just the election process for directors, the proposed SEC rule is congruous with our goal of bringing about an increase of meaningful shareholder oversight of public companies.

[11]*See* Securities Exchange Act of 1934, 15 U.S.C. § 78t(a) (2000).

laws; rather, they are intended to augment a regime whose purpose it is to prevent fraud on public investors by permitting oversight shareholders of public companies to act more like who they really are—the owners of a company. All other shareholders would benefit from this oversight.

II. REFORM OF INSIDER TRADING LIABILITY LAWS

Shareholders of publicly traded corporations are understandably reluctant to get involved in the affairs of the corporation for fear that they might acquire material nonpublic information. Their acquisition of material nonpublic information may either prevent them from making trades in the corporation's stock that they would ordinarily desire to make, or upon making any such trades subject them to insider trading liability if they are later deemed to have possessed material nonpublic information.[12] Although insider trading laws are a necessary control on deceptive and/or manipulative practices, the current laws stifle the benefit of having management being held accountable to shareholders by dissuading shareholders from making inquiries of management out of fear that such inquiries could cause them to become aware of material nonpublic information. Corporate governance would benefit by the creation of a safe harbor in the law for oversight shareholders that would allow them to establish an irrevocable trading plan for a fixed duration. As a result, oversight shareholders can act more like owners of the company by inquiring into the affairs of the company and holding management accountable for their actions.

A. *Existing Law*

The prohibition on insider trading has its roots in Section 10(b) of The Securities Exchange Act of 1934 (the Act)[13] and the Securities and Exchange Commission (SEC) rules (the Rules)[14] promulgated thereunder, and particularly in Rules 10b-5 and 10b5-1.[15] In addition to these regulatory sources, the litany of judicial decisions interpreting Section 10(b) of the Act and Rules 10b-5 and 10b5-1 have had an impact on defining insider trading liability. Furthermore, the Sarbanes-Oxley Act of 2002[16] also

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[12]*See generally* Securities Exchange Act of 1934, § 78j(b) (prohibiting the use of "any manipulative or deceptive device or contrivance" in the sale or purchase of registered and non-registered securities); 17 C.F.R. § 240.10b5-1 (2002) (defining when trading occurs "on the basis of" material nonpublic information).

[13]Securities Exchange Act of 1934, § 78j(b).

[14]17 C.F.R. § 240.10b.

[15]17 C.F.R. §§ 240.10b-5, 240.10b5-1.

[16]Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7201-7266 (2002).

contains provisions that have some impact on insider trading. However, these Sarbanes-Oxley provisions primarily relate to prohibitions on insider trading by officers and directors trading in the employer company's stock during black-out periods and the timing of filing insider reports with the SEC under Section 16 of the Act.[17]

Specifically, Section 10(b) of the Act, provides that it is:

> unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . *any manipulative or deceptive device or contrivance 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.*[18]

Further, SEC Rule 10b5-1 provides that:

> the "manipulative and deceptive devices" prohibited by Section 10(b) of the Act (15 U.S.C. 78j) and [Section] 240.10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.[19]

In spite of the vague prohibition under Section 10(b) of the Act on the use of any "manipulative or deceptive device," the Supreme Court established that insider trading is illegal when a person trades a security while in possession of material nonpublic information in violation of a duty to disclose the information or refrain from trading.[20] Recent cases have continued this line of reasoning.[21] Further, Rule 10b5-1 and cases constru-

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[17]*See id.*

[18]Securities Exchange Act of 1934, § 78j(b) (emphasis added).

[19]17 C.F.R. § 240.10b5-1 (2002) (citation omitted).

[20]*See* Chiarella v. United States, 445 U.S. 222, 227-32 (1980).

[21]United States v. O'Hagan, 521 U.S. 642, 651-53 (1997) (applying the "misappropriation theory," and in doing so recognized and validated the *Chiarella* rule (based on insiders with nonpublic information) as a complimentary rule to the misappropriation theory, which regulates

ing this rule establish that mere possession of material nonpublic information is insufficient to find a violation of Section 10(b); rather, the insider must use the information in making a trade.[22]

Nevertheless, and as the above Rules make clear, trading on the basis of material nonpublic information where the trading person is also found to have a fiduciary duty to others (such as other shareholders) is a violation of the Act and the Rules. Such a violation can subject the trader to criminal sanctions,[23] civil penalties,[24] which could be as much as three times the amount in pecuniary gain realized or loss avoided by the trader,[25] injunctive relief,[26] and private rights of action by injured "contemporaneous" traders; that is, persons who traded at the same time as the insider but without the access to the inside information.[27]

First, then, it is important to get a clear idea of what material nonpublic information constitutes. Quite simply, material information is defined as information that a reasonable shareholder would consider important in making decisions regarding the disposition of his or her shares.[28] Nonpublic information, obviously, is information not available to the public. Thus, the information is not accessible by persons that may trade on a public exchange and who do not have channels other than public channels to learn information about a publicly traded company. The lack of clearly defined parameters of what constitutes material nonpublic information is a major factor in a shareholder's reluctance to directly obtain any information from management, other than what is publicly released through annual reports and other periodic public filings and press releases. A shareholder who obtains any information from management may not be

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outsiders with nonpublic information). SEC v. Cochran, 214 F.3d 1261, 1264-65 (10th Cir. 2000) (finding a duty to disclose arises when a federal or state statute or common law recognizes a fiduciary relationship); Simon DeBartolo Group, L.P., v. Richard E. Jacobs Group, Inc., 186 F.3d 157, 169 (2d Cir. 1999).

[22]*See* 17 C.F.R. § 240.10b5-1; SEC v. Adler, 137 F.3d 1325, 1333-37 (11th Cir. 1998) (citing Supreme Court *dicta* in *O'Hagan*, 521 U. S. at 651; Dirks v. SEC, 463 U.S. 646, 660, 662 (1983); and *Chiarella*, 445 U.S. at 226-29, for the proposition that while the mere possession of material nonpublic information creates a strong inference that such information formed the basis for a trading decision, that inference can be rebutted by evidence that the information was in fact not used).

[23]*See* Securities Exchange Act of 1934, 15 U.S.C. § 78u(d)(1) (2000).

[24]*See id.* § 78u-1(a)(1).

[25]*See id.* § 78u-1(a)(2).

[26]*See id.* § 78u(d)(1).

[27]*See* Securities Exchange Act of 1934, 15 U.S.C. § 78t-1(a) (2000).

[28]*See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (defining material information in the context of violation of proxy rules under Rule 14a-9); *see also* Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (applying rule on material information from *TSC Indus., Inc.* to Section 10(b) violations of the Act).

capable of determining with reasonable certainty whether any such information so obtained would constitute material nonpublic information. Thus, shareholders, when faced with potentially receiving material nonpublic information and being restricted from trading in company shares, choose to be passive investors so as not be faced with trading restrictions or potential liability.

B. *Proposal for Change to Insider Trading Liability Laws*

As the above exposition of the current state of the law on insider trading makes clear, shareholders in publicly traded corporations, including oversight shareholders, will not, in today's climate and under the current insider trading laws, act more like the owners of a company should act. They are more likely to be passive investors and sell if they disagree with how management is running the company or are dissatisfied with management's performance. One way to achieve a higher degree of shareholder oversight of the company's activities is to create a safe harbor in the law that permits oversight shareholders of public corporations to make managerial inquiries and hold management accountable while at the same time permitting them to trade in shares on a limited basis and be shielded from the prospects of insider trading liability.

One such safe harbor is to provide that oversight shareholders of a public corporation could, before inquiring with management as to the affairs of the corporation, file a "trading plan" that sets buy and sell parameters on transactions in the shares of the corporation. These trading plans would have a minimum duration of at least six months. Upon filing their trading plans with the subject company, these oversight shareholders would then file with the SEC a filing similar to a Schedule 13D[29] or a Form 4[30] which publicly discloses that a trading plan has been filed without disclosing the specific trading parameters of the plan. The actual parameters of the trading plan would only be filed with the issuer. Market arbitrage opportunities would therefore be avoided that might otherwise cause share prices to go up or down in a type of "self-fulfilling prophecy" that could be brought about if the public knew the actual parameters of the plan. The filing would be a notice of the trading plan, and is not intended to alter Section 16 requirements if they otherwise apply.

For example, Mr. Brown is a one percent shareholder (an oversight shareholder) of XYZ Corp., a public corporation, whose shares are currently trading at $20 per share. Under this safe harbor proposal, Mr.

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[29]*See* 17 C.F.R. §§ 240.13d-1, 240.13d-101 (2003).
[30]*See id.* § 249.104.

Brown, prior to his inquiring with management of the corporation as to the corporation's affairs, would be able to file a trading plan with the issuer, which could provide, for example, that (1) if the share price falls to $15 a share, he will sell 250,000 of his shares and (2) if the share price rises to $25 per share, he will purchase an additional 100,000 shares, or anything else that Mr. Brown decides that his trading plan should provide. If Mr. Brown elects to deviate from his filed trading plan, he would, of course, be subject to the current insider trading liability regime.

Even though the Act currently permits the filing of a trading plan by a shareholder of a public corporation,[31] the current law merely provides that such trading plan would be an affirmative defense, which does not go as far as providing for a safe harbor.[32] The affirmative defense provided by Rule 10b5-1(c)(1)(i)(A)(3) allows the use of certain types of trading plans that, like the one suggested here, do not allow for the owner of the securities to exercise discretion as to the disposition of the securities.[33] But, since this is an affirmative defense to liability, an owner who files a trading plan comporting with Rule 10b5-1(c)(1)(i)(A)(3) may still have to fend-off the allegations of insider trading which could cost significant time and money. In the end, simply having to go through a suit (or possibly a criminal trial) regardless of the likely vindication is enough to deter owners from acting like owners and inquiring into the company's affairs.

In addition, it is not uncommon for public companies to institute a trading plan program for directors and/or officers who trade in the company's stock.[34] Directors and officers who participate in such trading plan programs would thereby avail themselves of the same affirmative defense under Rule 10b5-1(c)(1)(i)(A)(3). Although the practice is common among directors and officers, use of trading plans by shareholders is not common. What the proposal here suggests is not only to make the institution and use of trading plan programs more commonplace among oversight shareholders, but also to have these trading plans function as a true safe harbor and not just an affirmative defense to liability.

Provisions would also be needed to regulate the timing of filing of such trading plans and their expiration. Trading plans should be filed within a period of time after earnings are reported, such as between two

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[31] *Id.* § 240.10b5-1(c)(1)(i)(A)(3).

[32] *Id.* § 240.10b5-1(c).

[33] 17 C.F.R. § 240.10b5-1(c)(1)(i)(B)(3) (2003).

[34] *See, e.g.*, Press Release, Elizabeth Arden, *Elizabeth Arden, Inc. Approves Securities Trading Plans Under SEC Rule 10b.5* (Mar. 16, 2004), *available at* http:// biz.yahoo.com/bw/040316/165924_1.html; Press Release, PEC Solutions, Inc., *PEC Solutions' Officer/Director Adopts 10b5-1 Trading Plan* (June 11, 2002), *available at* http://www.pec.com/news/stock_plan.html.

days and ten days following an earnings report, and extend for at least six months. In addition, to prevent market disruptions, no trading under the trading plan would occur for two trading days after filing of the trading plan. This would allow the market to digest the trading plan news and allow investors to act as they deem appropriate on the information provided by the SEC filing ahead of the oversight shareholder. An oversight shareholder would not be obligated to file such a trading plan, but by failing to do so, they would not be able to avail themselves of the proposed safe harbor.

Oversight shareholders could opt-out of the safe harbor at the expiration of the trading plan after a required ninety-day "cooling-off" period during which the oversight shareholder would be required to trade in accordance with the previously filed trading plan. The ninety-day "cooling-off" period could function as a disincentive for oversight shareholders to opt-in to the safe harbor with the preconceived notion of opting out while still in the possession of material non-public information. Also, the "cooling-off" period would allow the SEC and others to keep closer track of potential abuses of the safe harbor.

While it is true that when taken together, the required six month duration of the trading plan plus the ninety-day "cooling-off" period can seem like a long time for an investor to be bound by the strictures of the plan, it must be kept in mind that the proposed safe harbor is meant to benefit the oversight shareholder who truly has a long-term association with the company. The safe harbor is not meant to benefit the short-term trader.

C. *Pros and Cons of Proposal*

What the above proposal basically accomplishes is that it allows an oversight shareholder to act like an owner, make inquiries into management and the affairs of the company, and hold management accountable for its actions while not being prevented from trading in shares.

Some might argue that such a regime, at least in theory, already exists under the rules and court interpretations cited above in the form of rebutting the charge that an insider traded on the basis of the material nonpublic information. The insider, so the argument goes, can provide evidence to the effect that he already intended to trade on such terms prior to gaining any such nonpublic information.[35] Indeed, in *Securities and Exchange Commission v. Adler*,[36] the Court sent back to the jury the question of whether one of the trades at issue in the case was made on the

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[35]*See infra* text accompanying note 37.
[36]137 F.3d 1325 (11th Cir. 1998).

basis of material nonpublic information. In *Adler*, the appellee was able to marshal a strong argument showing that he had planed to dispose of the same amount of shares prior to his acquisition of the material nonpublic information, although the transaction actually occurred after he acquired the information.[37] This, however, is not enough to assuage the fears of shareholders, particularly oversight shareholders, that they will have to endure a protracted and costly process only to determine that they have not violated the rules. In a nutshell, it is currently far less risky for the shareholder to simply avoid the issue by not receiving any nonpublic information than it is to inquire into the affairs of the company and later have to fend-off any insider trading charges or be prohibited in trading the shares.

Another argument against the adoption of the proposed safe harbor might be that the preparation and filing of trading plans would be burdensome on oversight shareholders. While it may be the case that the proposed safe harbor would amount to some measure of "paperwork" burden on oversight shareholders, it should be kept in mind that only shareholders who qualify (i.e., oversight shareholders) and who wish to take advantage of the safe harbor would need to comply with the trading plan requirements. So, availing oneself of the safe harbor is a matter of choice for the oversight shareholder. Further, the burden could be reduced by means of a simplified and streamlined procedure which would allow the oversight shareholder to prepare and submit a trading plan without the assistance of a professional.

III. REFORM OF SHAREHOLDER COMMUNICATION LIABILITY LAWS

A further barrier to a public shareholder's ability and incentive to act like a true owner of a public company stems from the restrictions on shareholder communications. Currently, it is very cumbersome and expensive for shareholders to communicate with one another to discuss issues and problems facing their companies and generate support for taking action.[38] For example, a shareholder who desires to wage a proxy fight to remove incumbent directors is not allowed to initiate wide scale communication without first filing a formal proxy statement,[39] which is cumbersome and expensive. Further, if a shareholder takes steps to com-

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[37] *Id.* at 1339 (deciding that whether appellee traded on the basis of material nonpublic information in light of appellee's strong evidence showing his intention to make the trade in question prior to his acquisition of the information is an issue for the jury and accordingly reversed district court's finding of summary judgment in favor of appellee).

[38] *See infra* text accompanying notes 39-40.

[39] *See* 17 C.F.R. §§ 240.14a-2, 240.14a-3.

municate with fellow shareholders and runs afoul of these proxy rules, the shareholder could face stiff liability.[40] Although the shareholder is allowed to "test the waters" prior to filing the proxy statement,[41] "testing the waters" does not amount to significant communication between shareholders under the SEC's current proxy rules.[42]

The cumbersome and expensive process which shareholders must go through (and potential liability for not following these rules) in order to discuss important issues facing their companies begs the question—why should the *owners* of a company be saddled with such a burden simply to communicate with fellow owners about their company; particularly in this day and age of the internet? It is understood that certain restrictions may need to remain in place to prevent smaller shareholders from causing "chat room" havoc, but these same restrictions should not similarly apply to oversight shareholders. Consistent with the positions previously presented in this article, without providing safe harbors to oversight shareholders, management is provided with a disincentive to act accountably to the shareholders. It seems intuitive that such owners should at least be allowed to *discuss* the affairs of the company together. After all, they generally have the most at risk, and therefore, have the greatest concern over the long-term financial success of the company. Further, the safe harbor proposed in this section, while only available to oversight shareholders, would benefit all shareholders. Smaller shareholders (who would not qualify for the safe harbor) would benefit by having issues brought to the fore by the oversight shareholders.

The proposed safe harbor discussed in detail below would call for the ability of the oversight shareholders to "opt in" and participate in telephonic discussions or on a secure web site that the public company would be required to set up and maintain to discuss salient company issues without the need to have these communications considered to be a "solicitation" or a "proxy" or a "solicitation for a proxy." Senior management and board members would have access to the discussions or website as well. By including only the oversight shareholders, a deluge of shareholder activism by persons who purchase company stock for the sole purpose of making shareholder proposals could be avoided. This will insure that the participants in communications under the safe harbor are the owners who have a true stake in the company over the long term. Only

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[40]Securities Exchange Act of 1934, 15 U.S.C. § 78(u) (2000). Indeed, if the proxy battle becomes hostile, as they almost always do, the insurgent will usually be sued by the incumbents.

[41]*See* 17 C.F.R. §§ 240.14a-2(b)(2), 240.14a-12.

[42]*See id.*; *see also* Taitz & Gotko, *supra* note 3, at 143-44 (discussing Rule 14a-2(b)(2) exemption from Regulation 14A when a solicitation is made to ten or less people).

when any of these oversight shareholders want to *actually* solicit proxies from these or other shareholders in order to call a proposal to a vote or elect or vote down particular board members, would the oversight shareholder be required to file a proxy statement. Allowing this communication would facilitate the flow of information among shareholders with significant stakes in the corporation. This way, the oversight shareholders would be allowed to directly hold management accountable and get more timely answers to their concerns.

In truth, however, stating that the proxy rules are unduly restrictive on shareholder communications does not quite give a fair and complete assessment of the situation. It is clear that the SEC has recognized the problems involved in restricting shareholder communications, and in 1992 the SEC amended the proxy rules with the intended purpose of facilitating shareholder communications.[43] The SEC also amended the rules in 1999, but in connection with issues not on point with this discussion.[44] These changes are taken into account in the brief outline of the proxy rules affecting shareholder communications set forth below; however, they have not gone far enough to be successful in achieving the desired result of fostering a meaningful level of shareholder interaction.

A. *Existing Law*

The basic provision governing shareholder communications is contained in Section 14(a) of the Act.[45] This provision states that:

> [i]t shall be unlawful for any person, by the use of the mails or by any means or instrumentality 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 or consent or authorization in respect of any security . . . .[46]

Generally, unless a particular communication is exempt from the requirements of the proxy rules, any person making a "solicitation" is required to first file a preliminary or definitive proxy statement with the

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[43]Taitz & Gotko, *supra* note 3, at 136-38.
[44]*See* HAROLD S. BLUMENTHAL, SECURITIES LAW HANDBOOK § 17:8, at 943 (2003).
[45]Securities Exchange Act of 1934, § 78n(a).
[46]*Id.*

SEC under Rule 14a-3 and provide this statement to the solicited person either prior to or concurrently with the solicitation.[47] The proxy statement must be prepared according to Rule 14a-101[48] which is, to say the least, cumbersome and expensive to prepare as it would typically require the assistance of a professional in order to ensure compliance.[49]

Critical to understanding these proxy rules is understanding two key terms used in Section 14(a); namely, the terms "solicitation" and "proxy." It is these two terms that determines whether a communication by a shareholder is subject to the proxy rules by virtue of the communication being considered a "solicitation for a proxy."[50] According to the SEC Rules, "[t]he term 'proxy' includes every proxy, consent or authorization within the meaning of section 14(a) of the Act."[51] Further, "[t]he consent or authorization may take the form of failure to object or to dissent."[52] This definition is, therefore, extremely broad and, as one commentator noted, "includes, among other things, communications to shareholders to authorize a demand of a shareholder's list or to obtain funds to finance a proposed proxy contest."[53]

Arguably more important is the SEC's definition of "solicitation." According to the SEC Rules, the terms "solicit" and "solicitation" include:

> (i) [a]ny request for a proxy whether or not accompanied by or included in a form of proxy; (ii) [a]ny request to execute or not to execute, or to revoke, a proxy; or (iii) [t]he furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.[54]

It is clear that subpart (iii) of this Rule potentially makes any shareholder communication subject to the proxy requirements if the particular issue eventually ends up in a shareholder vote or even becomes contested. Furthermore, if shareholders have enough concern for a particular issue, for example, the replacement of a particular director, it will surely be contested, and in such a case, if the shareholder did not file a proxy

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[47]*See* 17 C.F.R. § 240.14a-3(a) (2002).

[48]17 C.F.R. § 240.14a-101 (2003).

[49]*See id.*

[50]It should be noted, however, that there are a litany of exceptions, many of which were prompted by the 1992 and 1999 amendments, which are discussed further in this article.

[51]17 C.F.R. § 240.14a-1(f).

[52]*Id.*

[53]Taitz & Gotko, *supra* note 3, at 138.

[54]17 C.F.R. § 240.14a-1(l).

statement with the SEC as required under the Rules, the shareholder could be held liable for a violation of the Act.

As mentioned above, there currently are many exceptions to the proxy rules that were intended by the SEC to foster more effective shareholder communications. For example, there is the so-called "intent to vote" exception under Rule 14a-1(1)(2)(iv).[55] This provides that the definition of "solicitation" generally does not apply to statements by shareholders indicating how the shareholder intends to vote in respect of a certain issue and the reason for the shareholder's choice, so long as the shareholder is not engaged in a proxy solicitation or a solicitation that is specifically exempt under Rule 14a-2.[56] The shareholder may use the "intent to vote" exception to communicate with other shareholders, but only if the statement is in a public forum (speeches, newspapers, broadcast media, etc.),[57] if the shareholder is a fiduciary to another shareholder,[58] or if the shareholder is asked to provide further information after such shareholder has made a previous "intent to vote" statement.[59]

It should also be noted that the "intent to vote" exception is not really an exception to Rule 14a-3 requirement of filing a proxy statement; rather the "intent to vote" statement takes this type of statement out of the definition of a "solicitation" and thus makes the "intent to vote statement" *not* subject to Section 14(a) of the Act. While this may seem to be a broad avenue allowing shareholders to freely communicate, as discussed below, this avenue is more limited than it seems.

To better understand the ineffectiveness and narrowness of the above exceptions, it is necessary also to examine the true "exemptions" to Rule 14a-3's proxy statement requirements that operate to take certain types of communications out of the proxy rules in spite of the lack of a specific exclusion under the definition of "solicitation."[60] Basically, Rule 14a-2 exempts communications of an eligible person (i.e., those not included in the lengthy list in this Rule of persons who cannot avail themselves of this exemption) from the requirement to file and distribute a Schedule 14A (proxy statement) as required by Rule 14a-3, if the person communicating the solicitation is not seeking a proxy and is not furnishing a proxy to the recipient of the communication.[61] Even under this exemption, however,

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[55]Taitz & Gotko, *supra* note 3, at 140.

[56]17 C.F.R. § 240.14a-1(1)(2)(iv); *see also* Taitz & Gotko, *supra* note 3, at 140 (explaining "intent to vote" statements).

[57]17 C.F.R. § 240.14a-1(1)(2)(iv)(A).

[58]*Id.* § 240.14a-1(1)(2)(iv)(B).

[59]*Id.* § 240.14a-1(1)(2)(iv)(C).

[60]*Id.* § 240.14a-2(b)(1).

[61]17 C.F.R. § 240.14a-2(b)(1).

certain larger shareholders (whose interest is valued at $5 million or more) must file a separate "Notice of Exempt Solicitation" under Rule 14a-6(g)(1).[62] Further exemptions are also available under Rule 14a-2(a), which include "[a]ny solicitation through the medium of a newspaper advertisement" containing very limited information.[63] In this day and age, such means of communications are archaic and not likely to be used or are ineffective in providing true shareholder communication and owner oversight. Moreover, there is the often cited Rule 14a-2(b)(2), which is commonly known as the "test the waters" provision, that exempts nearly all communications to ten or fewer shareholders by any person other than the registrant.[64] Communications limited to ten or fewer shareholders should not be deemed meaningful wide scale shareholder communications, and thus, the "test the waters" exception is ineffective at producing useful and desirable owner oversight. Further, keeping track of whether a communication is limited to ten or fewer shareholders places an additional impediment to more meaningful communication between shareholders as the communicating shareholder must ensure that the communication is not disseminated beyond the ten shareholder limit.

As previously mentioned, these exceptions and exemptions are narrower than they seem. The "intent to vote" type communication which excludes such statements from the meaning of "solicitation" becomes inoperable, retroactively, if the shareholder later engages in a proxy solicitation.[65] Further, the language of Rule 14a-1(l)(2)(iv) clearly states that if the shareholder communication is exempt under one of the specific exemptions of Rule 14a-2(b)(1) (as opposed to exclusion from the meaning of "solicitations"), the communication can no longer be covered under the "intent to vote" provision.[66] As noted by one commentator, neither the "intent to vote" provision of Rule 14a-1(l)(2)(iv) nor the specific exemptions contained in Rule 14a-2(b)(1) can be relied upon by any person who later engages in a non-exempt solicitation.[67] Therefore, the practical effect of this is that a shareholder who first relies on the "intent to vote" or any other exemption in order to make a communication, must be sure

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[62] *Id.* § 240.14a-6(g)(1).

[63] *Id.* § 240.14a-2(a)(6); *see also* Taitz & Gotko, *supra* note 3, at 143 (discussing 14a-2(a) exemptions).

[64] 17 C.F.R. § 240.14a-2(b)(2).

[65] *See id.* § 240.14a-1(l)(2)(iv); *see also* Taitz & Gotko, *supra* note 3, at 140 (explaining that under Rule 14a-1(1)(2)(iv) "'solicitation' does not apply to 'intent to vote' disclosures").

[66] *See* 17 C.F.R. § 240.14a-1(l)(2)(iv).

[67] Taitz & Gotko, *supra* note 3, at 143-44. As noted in *supra* note 40, contested elections usually bring lawsuits between insurgents and incumbents and insurgents are frequently called to task to defend their pre-proxy communications. For an insurgent, these exceptions become an "Achilles heel" in litigation.

beforehand that he will not eventually seek a proxy.

In short, while the amendments on their face may have somewhat relaxed shareholders' ability to communicate among themselves without going through the cumbersome proxy process, in practice these changes have not gone far enough in creating the kind of owner oversight needed to achieve the desirable high level of accountability to shareholders that is sought here.

Furthermore, Section 13(d) of the Act requires persons acquiring more than five percent of a company's equity securities to file certain disclosures and expose themselves to certain potential liabilities for failure to provide such disclosure filings.[68] Additionally, Section 13(d) of the Act also provides that two or more persons who "act as a partnership, limited partnership, syndicate or *other group* . . . shall be deemed a 'person' for the purposes of [Section 13(d) of the Act]."[69] Accordingly, shareholders are concerned with incurring potential liability by being held to have "acted in concert" by engaging in any wide scale shareholder communication and not thereby filing the required Schedule 13D to the extent that such "group" owns in the aggregate more than five percent of the company's equity.[70]

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[68]*See* Securities Exchange Act of 1934, 15 U.S.C. § 78m(d) (2000).

[69]*See id.* § 78m(d)(3) (emphasis added).

[70]*See* Blake A. Bell, *Do Shareholder Activists Violate Federal Proxy Solicitation Laws Through Internet Message Boards?* originally published at http://www.wallstreetlawyer.com in Sept. 1998, currently *available at* http://www.simpsonthacher.com/ siteContent.cfm?contentID= 4&itemID=81&focusID=275. *See also* Bath Indus., Inc. v. Blot, 427 F.2d 97 (7th Cir. 1970) (holding that once a "common objective" is demonstrated and a subsequent purchase is made by a member of the group, a rebuttable presumption arises that the purchase was made pursuant to an agreement of the "group" to purchase additional shares requiring the 13D filing). The *Bath Industries* holding, that an agreement to acquire additional shares must precede the necessity to make the 13D filing, has been disputed. *See* GAF Corp. v. Milstein, 453 F.2d 709, 718 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972). Nevertheless, courts, including the *GAF Corp.* court, have supported the *Bath Industries* principle that a finding of an agreement, combination or conspiracy of some sort is required to necessitate the 13D filing. *Id.*; *but see* TexasGulf, Inc. v. Canada Dev. Corp., 366 F. Supp. 374, 403 (S.D. Tex. 1973); Corenco Corp. v. Schiavone & Sons, Inc., 488 F.2d 207, 217-18 (2d Cir. 1973) (affirming the granting of a permanent injunction by the district court, even though in that case a "conspiracy" was not found to exist). Any such agreement, combination, or conspiracy need not be written or formal. *See* Jewelcor, Inc. v. Pearlman, 397 F. Supp. 221, 250 (S.D. N.Y. 1975); Twin Fair, Inc. v. Reger, 394 F. Supp. 156, 160 (W.D. N.Y. 1975); Graphic Scis., Inc. v. Int'l Mogul Mines Ltd., 397 F. Supp. 112, 124 n.35 (D.D.C. 1974). For additional cases addressing required 13D filings for a "group," see Citizens First Bancorp, Inc. v. Harreld, 559 F. Supp. 867 (W.D. Ky. 1982) (concluding that a "group" was found where dissenting directors and shareholders agreed to call a special shareholders' meeting and vote their shares together in an attempt to remove various directors); Scott v. Multi-Amp Corp., 386 F. Supp. 44, 60-61 (D. N.J. 1974) (holding that defendant director shareholders were a "group" on basis of board meetings); and SEC v. Savoy Indus., Inc., 587 F.2d 1149, 1165 (D.C. Cir. 1978) (finding that shareholder's participation in activity that led to a change in corporate leadership made him a part of a "group"). For an overview of the foregoing, see SEC v. Savoy Indus., Inc., 587 F.2d 1149 (D.C. Cir. 1978).

Since it is unclear as to what degree of wide scale shareholder communication would be required to be held to be a "group" under Section 13(d) of the Act, shareholders of public companies are reluctant to engage in any meaningful communications with other shareholders.

B. *Proposal for Change to Shareholder Communication Laws*

As the foregoing explanation of the relevant proxy rules makes clear, the current proxy rules place significant restrictions on a shareholder's ability to communicate with fellow shareholders, not to mention the complexity and uncertainty involved in determining whether a communication is subject to the requirement of filing a proxy statement. Even in light of the 1992 and 1999 amendments which allow "intent to vote" statements under certain conditions and exempt certain "solicitations" from the proxy rules, the shareholder's ability to communicate with other shareholders is hindered to such an extent that there can be little meaningful owner oversight of management .[71] In order to increase the level of oversight and consequential accountability of management to shareholders, a safe harbor should be created that would allow oversight shareholders of public corporations to communicate freely with other oversight shareholders on any issue regardless of whether the issue later becomes the subject of a proxy solicitation or a even a proxy fight.

What is suggested here would call for public corporations to be required to set-up and maintain a restricted and secure private "chat room"-style web site that the oversight shareholders could use to communicate with each other and/or directly with management and the board. In addition to or instead of websites, public companies could set up conference calls between the shareholders, management, and the board. Shareholders permitted access to such web sites or conference calls would be limited to oversight shareholders. Further, the oversight shareholders who avail themselves of the safe harbor would have to file a trading plan. The trading plan would ensure that the oversight shareholders do not receive an unfair advantage because of access to nonpublic information that might surface during shareholder communications. This web site could then be used by the oversight shareholders to discuss, consider, or post messages on any issue they believe to be important. The chat room would serve as a forum for the oversight shareholders with similar larger stakes in the company and with long-term investment objectives to exchange ideas and share concerns. This would in effect eliminate the concerns that such oversight share-

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[71] *See supra* text accompanying notes 43-44.

holders currently have with regard to the current complex proxy rules. In fact, the proposal would make communication possible out of what is currently only the limited ability of shareholders to "test the waters" by communicating to fewer than ten shareholders under Rule 14a-2(b)(2). The proposed safe harbor would allow issues and concerns (and assistance) to be brought directly to management by the oversight shareholders, thereby allowing the oversight shareholders to act more like owners.

C. *Pros and Cons of the Proposal*

The proxy rules do serve legitimate purposes, as the courts have noted. Proxy rules prevent undue influence on less sophisticated investors, and ensure that the investors are well informed as to the nature of the issues upon which their shares will be voted. Some might argue that allowing oversight shareholders to communicate freely outside of the proxy rules allows them to exert influence to the detriment of non-participating shareholders and management. Influence should only be presumed once a shareholder (or anybody for that matter) actively solicits proxies on matters to be formally voted on by the other shareholders. All shareholders would benefit and "piggy-back" on the probing, assistance, and issues that come out of discussions among the oversight shareholders. Again, this is not to suggest that the proxy rules would not apply. They, however, would only apply once there is a formal solicitation to garner support for or opposition to a matter up for a vote.

A further benefit flowing from this proposal might also be in the form of reduced litigation brought about by proxy fights. Proxy fights often lead to unnecessary litigation by one party accusing the other of not following the requirements of the proxy rules.[72] Litigation is often used by a party for tactical purposes during a proxy fight or as a means to reverse or partially reverse the decision or stall the taking of any action that received a favorable vote.[73] Allowing more liberal shareholder communica-

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[72]In referring to the various statutory remedies available for violation of the proxy rules, one commentator notes, "In the real world all these statutory sanctions have been dwarfed by the courts' implications of *private* actions for violations of the rules." LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 448 (Little, Brown, & Co. 3d ed., 1995). For a thorough discussion on increased litigation resulting from the judicially construed implied right of action under the 1934 Act, see Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws—The Commission's Authority*, 107 HARV. L. REV. 961 (1993-1994). *See also* J.I. Case Co. v. Borak, 377 U.S. 426, 430 (1964) (recognizing a private right of action under the 1934 Act and proxy rules). *See also generally* Marc I. Steinberg & William A. Reece, *The Supreme Court, Implied Rights of Action, and Proxy Regulation*, 54 OHIO ST. L.J. 67 (1993) (analyzing securities law, implied rights of action, and corporate governance).

[73]*See Borak*, 377 U.S. at 427-30.

tion would take one weapon out of the arsenal that could be used by prospective proxy litigants.

Still others may argue that if the rules are relaxed to such an extent as to pose no threat of liability in the case of abuse, abuse will abound. While there is always the potential for abuse of rules (or lack of them), this proposal does not significantly alter the existing regulatory regime because oversight shareholders seeking to solicit proxies will eventually have to comply with the rules when widespread shareholder communication is sought.

IV. REFORM OF MANAGERIAL LIABILITY LAWS FOR "CONTROLLING PERSONS"

Aside from the potential of being found liable for insider trading and running afoul of the proxy rules, there is yet another reason why shareholders are unwilling to become involved in the affairs of their public companies. Shareholders have an understandable reluctance to get involved in the managerial affairs of their companies because if they become too involved, they may acquire "controlling person status" pursuant to Section 20(a) of the Act.[74] If a shareholder acquires controlling person status in their company, they may then be held liable to other shareholders or regulators to the same extent as the management or directors for any violation of the substantive provisions of the Act.[75]

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[74]*See* Securities Exchange Act of 1934, 15 U.S.C. § 78t(a) (2000).

[75]*See id.* It is also worthy of note that certain other statutes (unrelated to securities) may also impose liability on a "controlling person" (e.g., "responsible person" under the tax code or expansive definition of "owners/operators" under environmental regulations and the expansive definition of a "fiduciary" under the pension and welfare laws) for the acts of another. The threat of liability from these other statutes then would also be a factor militating against shareholder involvement in the affairs of management. For example, under the tax code, environmental regulations and pension and welfare statutes, a shareholder could potentially be shouldered with personal liability if management committed a violation and it determined that the shareholder "controlled" management or falls within the definition of "responsible person" (tax) or the definition of "owner/operator" (environmental) or the definition of a "fiduciary" (pension welfare). For secondary liability in the tax context, see I.R.C. § 6672(a) (West 2002) (mandating penalties for any person who willfully fails to pay over any tax); and cases construing the so-called "responsible person" under the Tax Code as someone other than the "primary" violator, Bowlen v. United States, 956 F.2d 723, 726 (7th Cir. 1992) (holding the shareholders of a corporation liable for unpaid taxes); Ruth v. United States, 823 F.2d 1091, 1092 (7th Cir. 1987) (affirming the jury's finding that Ruth was a "responsible person" by being in control of distributing funds to employees and withholding taxes); White v. United States, 372 F.2d 513, 522 (U.S. Ct. Cl. 1967) (concluding that the president of a corporation who had "general supervision over the affairs of the corporation" was liable for the corporation's unpaid taxes). For secondary liability in the environmental context, see Comprehensive Environmental Response and Liabilities Act (CERCLA), 42 U.S.C.A. § 9607 (West 2003); and Vermont v. Staco, Inc., 684 F. Supp. 822, 831-

Moreover, these shareholders are even more reluctant to insist on, or even attempt to exert influence with respect to management or policy changes, when a company's financial fortune may be "going south." It is when a company is experiencing financial difficulties that shareholder/owner oversight is probably most crucial to protecting shareholders' interest and the viability of the company. Unfortunately, it is during these adverse financial times that public shareholders are most concerned with being held liable for the activities of management and prefer to remain silent or sell their investments. In addition, during bad financial times, management may feel pressured to achieve results by taking less desirable actions to temporarily or artificially try to paint a better financial picture of the company rather than take the actions needed to actually improve the financial prospects of the company on a longer term basis. This could lead to their cutting corners, trying to mask certain deficiencies and installing temporary fixes to make the company appear more favorable than it actually may be to protect their jobs or possibly hide poor judgments or other actions that may have caused the difficulties. If an oversight shareholder acquires controlling person status in these situations, he or she may become personally liable for a "bundle" of problems when all the

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32 (D. Vt. 1988), *vacated on other grounds*, No. 86-190, 1989 U.S. Dist. LEXIS 17341, at *30 (D. Vt. Apr. 20, 1989) (broadly construing the CERCLA definition of "owners and operators" to include shareholders who had decision making authority); *see also* City of N. Miami, Fl. v. Berger, 828 F. Supp. 401, 411 n.16 (E.D. Va. 1993) (deeming a corporate officer-shareholder an "operator" by analogizing the corporate officer-shareholder's conduct with the conduct of the shareholder in *Staco*); Kelley v. Thomas Solvent, Co., 727 F. Supp. 1554, 1560 n.3 (W.D. Mich 1989) (citing Idaho v. Bunker Hill Co., 635 F. Supp. 665 (D. Idaho 1986), for the proposition that ownership interest in a corporation along with active management is enough to find that a person is an "owner/operator" under CERCLA and therefore could be liable). Similarly, in the pension fund (ERISA) context the term "fiduciary" is quite broadly construed and could include a shareholder if such a shareholder exercised the requisite degree of authority or control. Courts have used a functional test to determine whether someone is a fiduciary under ERISA by examining whether that person has actually performed one or more functions enumerated at Section 3(21)(A) of ERISA. *See* JAMES F. JORDEN ET AL., HANDBOOK ON ERISA LITIGATION § 3.02[A] (Aspen 2d ed. Supp. 2004). Several cases also demonstrate the relative ease by which a shareholder could be deemed a "fiduciary" by exercising some level of control. *See, e.g.*, Blatt v. Marshall & Lassman, 812 F.2d 810, 812 (2d Cir. 1987) ("[F]iduciary status exists with respect to any activity enumerated in the statute over which the entity exercises discretion or control."); Credit Managers Ass'n v. Kennesaw Life & Accident Ins. Co., 809 F.2d 617, 625 (9th Cir. 1987) ("An ERISA fiduciary includes anyone who exercises discretionary authority over the plan's management, anyone who exercises authority over the management of its assets, and anyone having discretionary authority or responsibility in the plan's administration." (citation omitted)). It thus becomes clear that a safe harbor enacted to exclude the oversight shareholder from potential liability of Section 20(a) of the Act must also exclude the oversight shareholder from the potential liability found in other statutory schemes. The liability potentially imposed by these other statutes (and court interpretations of them) is, generally speaking, rooted in the "violator's" exercise of authority or control.

shareholder was trying to do was help.

Oversight shareholders should not be afraid that by holding management accountable, making inquiries into the actions of management or by helping, they might be exposed to undue liability if their actions are deemed to have risen to the level of a "controlling person." As owners, they should be permitted to act like owners and not be concerned with exposing themselves to potential liability for more than their investment or more than any other shareholder simply by inquiring into managerial affairs as a means of protecting their investment. Further, all public companies should invite to their board meetings and provide board informational packages, including audit and compensation committee packages, to all oversight shareholders. Then, in addition to simply protecting their investment, oversight shareholders could actually help to improve their company as they become aware of management decisions and probe and ask questions and help without fear of acquiring "control person" status.

A. *Existing Law*

The provision of the Act that governs and can impose "controlling person status" on a shareholder is set forth in Section 20(a) of the Act. Section 20(a) provides that:

> [e]very person who, directly or indirectly, controls any person liable under any provision of this chapter . . . shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.[76]

The SEC has further defined "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[77] And, as one commentator has observed, the legislative history of Section 20(a) also shows that control could exist through ownership of shares, by virtue of a contract, an agency relationship,

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[76]The Securities Exchange Act of 1934, § 78t(a).
[77]17 C.F.R. §§ 240.12b-2(f), 230.405 (2002).

or a lease.[78] Thus, a shareholder who attempts to make inquiries into management's actions or hold management otherwise accountable could be deemed to possess the power to direct or cause the direction of management and policies of the corporation. As such, a shareholder could be subject to liability for a violation of the Act.

Therefore, as Section 20(a) and the SEC interpretation of "control" make clear, if any person, including a shareholder of a corporation, is deemed to have even indirect control over management, and management commits an act for which liability could be imposed under the Act, the shareholder could be held jointly and severally liable for such actions. Although courts and legal commentators have often used the term "secondary liability" in connection with controlling person liability, this is perhaps best thought of as a form of vicarious liability.[79] Further, while the additional language in Section 20(a) strongly suggests that the joint and several liability of the controlling person will not be imposed in situations where the controlling person did not (directly or indirectly) induce the wrongful conduct *and* acted in good faith, courts have varied on their interpretations of this exculpatory language, especially when there is an aggrieved innocent third party in need of compensation.[80]

A number of circuit courts of appeal, namely the Seventh, Eighth, Ninth and Eleventh Circuits, have construed the control person liability provision of Section 20(a) liberally and have not required plaintiffs to demonstrate that a defendant *exercised* control over the specific transaction or activity upon which the violation of the Act is predicated.[81] Although

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[78]Loftus C. Carson II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 NOTRE DAME L. REV. 263, 274 (1996) (citing H.R. NO. 73-1383, at 26 (1934), *cited in In re* Enron Corp. Sec., Derivative & ERISA Litig., No. H-01-3624, 2003 U.S. LEXIS 1668, at *32 (S.D. Tex. Jan. 28, 2003)).

[79]*Black's Law Dictionary* defines "secondary liability" as "[a] liability which does not attach until or except upon the fulfillment of certain conditions; as that of a surety, or that of an accommodation indorser." BLACK'S LAW DICTIONARY 1351 (1990). *Black's* defines "vicarious liability" as "[t]he imposition of liability on one person for the actionable conduct of another, based solely on a relationship between the two persons." *Id.* at 1566. Although Section 20(a) liability might not attach until the fulfillment of a certain condition, i.e., that the liable party is a control person, Section 20(a) is quite clearly placing liability on a person for the "actionable conduct of another" if they are found to be a controlling person.

[80]S. Scott Luton, *The Ebb and Flow of Section 10(B) Jurisprudence—An Analysis of* Central Bank, 17 U. ARK. LITTLE ROCK L. REV. 45, 76-77 (1994).

[81]*In re* Villa, 261 F.3d 1148, 1152 (11th Cir. 2001) (indicating that control person liability can be established if the defendant had the general power to control the affairs of the entity that is primarily liable at the time of the violation, and had the power to directly or indirectly control the specific policy or transaction resulting in the primary liability); Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873, 880 (7th Cir. 1992) ("We have long viewed the statute as remedial, to be construed liberally, and 'requiring only some indirect means of discipline or influence short of actual direction to hold a "control person" liable.'" (citation omitted));

the holdings of these courts are not entirely uniform in the approach for establishing control person liability, it seems clear that the control person need only *have* control, direct or indirect—they need not have exercised that control.[82] Therefore, under the law of these circuits, shareholders who might insist on management or policy changes might well be deemed by a court to have the requisite direct or indirect control which is indeed enough for a plaintiff to state a cause of action against the control person (notwithstanding that there may be an affirmative defense).

Although "control person" liability is most often found in the director/officer or broker-dealer context, certain commentators have indicated that "control person status" could exist with respect to shareholders merely in their capacity as shareholders.[83] The American Law Institute (ALI) has indicated that a shareholder could be considered a "controlling shareholder" if the person "[o]therwise exercises a controlling influence over the management or policies of the corporation or the transaction or conduct in question by virtue of the person's position as a shareholder."[84] The ALI further indicates that a person who, either alone or pursuant to an arrangement with others, has the power to vote more than twenty-five percent of the shares of a corporation "is *presumed* to exercise a controlling influence over the management or policies of the corporation."[85] The position of the ALI and certain courts make it clear that only a fact specific inquiry would show whether a shareholder has risen to the level of a "controlling person." Once a court determines that a shareholder is a "control person," the burden then shifts to the controlling

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Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1575 (9th Cir. 1990) (holding in part that exercise of actual power or culpable participation in the violation is not a requirement for finding control person liability under Section 20(a)); *see also* Metge v. Baehler, 762 F.2d 621, 631 (8th Cir. 1985) (describing the second part of a two-part test to determine controlling personal liability which requires proof that the defendant possessed the power to control the specific transaction, but does not require proof that this power was exercised).

[82]*See supra* note 81 and accompanying text. For an overview of control person liability, see Laura Greco, *The Buck Stops Where?—Defining Controlling Person Liability*, 73 S. CAL. L. REV. 169 (2000).

[83]*See* Carson, *supra* note 78, at 285-86.

[84]PRINCIPLES OF CORPORATE GOVERNANCE ANALYSIS AND RECOMMENDATIONS § 1.10(a)(2) (ALI) (1994).

[85]*Id.* § 1.10(b). Several courts have also hinted that shareholder status might be enough to find "controlling person status" although these cases usually involve additional facts. *See, e.g.*, Klein v. King, [1989-1990 Transfer Binder] Fec. Sec. L. Rep. (CCH) ¶ 95,002, at 95,610 (N.D. Cal. Mar. 26, 1990) (such as a shareholder's relationship with a director); *In re* American Bus. Computers Corp. Sec. Litig., [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,103, at 98,807 (S.D.N.Y. Nov. 16, 1993) (shareholder's public statement that it intended to review a press release); Suppa v. Montano, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,348, at 92,306 (W.D. Mo. Feb. 28, 1989) (shareholder's relationship to the corporation by virtue of guaranties he provided on loans violated Section 11 of the Securities Act of 1933).

person to show that they acted in good faith and did not induce the violation of the Act. This after-the-fact based approach to determine control person liability under Section 20(a) is certainly enough to make the most well-intentioned shareholders shy away from making any inquiries with management and instead use the only safe vehicle at their disposal—selling-off their interests.

In contrast to the position of the circuits listed above, the Second and Third Circuits have required plaintiffs to demonstrate (1) active participation in the operations of the company and in the primary violation of the Act and (2) actual control by the defendant over the transaction at issue.[86] In making their decisions, these courts have focused on some of the exculpatory language at the end of Section 20(a) which sets up an affirmative defense to control person liability if a defendant can show he "acted in good faith and did not directly or indirectly *induce* the act or acts constituting the violation or cause of action."[87] While it may be true that certain courts have taken a more restrictive view of Section 20(a), before shareholders decide to act like owners and make adequate managerial inquiries, it will need to be made clear to them that by doing so they will not be exposing themselves to a higher level of liability than a passive investor.

Since activist shareholders face the prospect of being held jointly and severally liable as a controlling person along with management for violations of the Act, Section 20(a) clearly hinders shareholder involvement in the affairs of their company. This impediment to shareholder oversight is further heightened by the uncertainty derived from varying court interpretations of "controlling person" and the exculpatory language of Section 20(a). Given this climate, it is no wonder that shareholders of public companies choose to keep a clear separation between themselves and management and directors.

B. *Proposal for Change to "Controlling Person Status" Laws*

Shareholder/owner oversight, perhaps the most effective tool for keeping the management and directors of a public corporation accountable to the shareholders and to the market in general, is hindered under the current Section 20(a) controlling person regime. It must be said, however,

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[86]*See In re* Enron Corp. Sec., Derivative & ERISA Litig., No. H-01-3624, 2003 U.S. LEXIS 1668, at *37 (S.D. Tex. Jan. 28, 2003) (referring to approach used in Second and Third Circuits as "culpable participation" test) (citing SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1472 (2d Cir. 1996); Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 885 (3d Cir. 1975)).

[87]Securities Exchange Act of 1934, 15 U.S.C. § 78t(a) (2000) (emphasis added).

that Section 20(a) (and most of the securities regulation in the United States) is rooted in the overall policy goal to protect investors and public markets and that, without Section 20(a), certain "controlling" persons might well be able to insulate themselves from potential of liability for violating the Act. Nevertheless, a safe harbor should be in place to permit oversight shareholders to act like owners without the worry of obtaining "controlling person status."

A safe harbor should be created that would exempt oversight shareholders from liability under Section 20(a) so long as the management, compensation, or policy changes requested or questioned by the oversight shareholder do not benefit that shareholder personally (no conflicts of interest), and are rather for the purpose of benefiting all shareholders. Therefore, for example, under the safe harbor these oversight shareholders could request or probe into a change of management without incurring "control person" liability if there are otherwise no conflicts of interest.[88] To take advantage of the safe harbor, however, the oversight shareholder would also have to file a trading plan (as mentioned above in connection with insider trading liability).[89] This requirement will provide a check against the possibility of an oversight shareholder acquiring material nonpublic information about the company and using it to the detriment of other shareholders or the market as a whole. Further, the proposed safe harbor should be broad enough to permit the oversight shareholder to probe any board member or executive officer of the company concerning the company's activities. In addition, the safe harbor would require public companies to invite oversight shareholders to their board meetings (and audit and compensation committee meetings) to attend as "observers," and the companies would also have to provide them with the same board informational packages that are distributed to board members, including audit and compensation committee reports. This would be a further way to increase the level of accountability to shareholders. Then the oversight shareholders, by being privy to board meetings and information received by the board, would be better equipped to ask questions and probe and would likely do so in a manner more targeted towards the value of their investment. Other shareholders would also benefit knowing that similarly situated larger shareholders are actively probing and attending corporate governance meetings.

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[88]The safe harbor should also operate to exempt these oversight shareholders from potential liability under the other legislative schemes mentioned *supra* note 75 which would also be equally required if the safe harbor is to achieve its goal of diminishing shareholder fear of liability in order to engender heightened shareholder oversight.

[89]*See supra* Part II.B.

Finally, as part of this proposed safe harbor, additional legislation would need to be enacted that would bar lawsuits brought by other shareholders against oversight shareholders simply by virtue of their oversight. Shareholders can bring lawsuits against management (e.g., usually for breach of a managerial duty owed to shareholders or the company), but the oversight shareholder should not be exposed to these types of lawsuits simply because they have exercised their oversight under the safe harbor. This bar on lawsuits against the oversight shareholder should, however, only become operative if the oversight shareholder has no conflicts of interest. Therefore, a family, for example, who owns a large stake in a public company and manages the business and thus has potential conflicts of interest, would not qualify as an oversight shareholder.

C. *Pros and Cons of Proposal*

Some might criticize the proposal to amend the control person liability law by arguing that the exculpatory language of Section 20(a), and particularly its "good faith" requirement, should be enough to eliminate the chance of a shareholder being shouldered with managerial liability as a control person. It must be recalled that this, however, is an affirmative defense to an action once it is brought against the shareholder and, while the shareholder may meet the good faith requirement and otherwise not have been involved in the violation of the Act, he must still defend a lawsuit and incur costs as a result. In addition, some courts, as cited above, have found that exercise of control may not be necessary for finding control person status.[90] This is surely enough to cause any shareholder to avoid involvement in his company's affairs in the first instance. Owners will not get involved unless it is clear to them that their actions will not expose them to liability. Therefore, by enacting legislation providing for a safe harbor to insulate oversight shareholders from exposure to such managerial liability, oversight shareholders would be more prone to act like true owners and hold management accountable for their actions and insist on changes when changes are in fact necessary.

Another, almost obvious, consequence of relaxing the current control person regime is that the boards and management of public companies will no doubt have to devote more energies and resources to fielding phone calls and e-mails from oversight shareholders who would no longer be held in check by fear of incurring liability as a controlling person. It must be recognized, however, that this is not likely to be a big problem because the

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[90] *See supra* note 81 and accompanying text.

safe harbor is limited to only one percent or greater shareholders (who have filed a trading plan). This would greatly narrow the field of would-be information seekers. In addition, the consequence of more corporate resources being dedicated to answering the questions of shareholders is not necessarily negative as it will directly provide the accountability to owners that is currently lacking. One need only consider the recent financial crises to realize that the price that shareholders pay without the accountability is surely greater than the price (in company resources) to field phone calls and e-mails and answer oversight shareholder inquiries.

V. CONCLUSION

Measures must be taken to restore public confidence in the securities markets. The Sarbanes-Oxley Act and SEC proposals, while positive, do not go far enough. They are designed to treat symptoms, not causes. As discussed in this article, confidence would best be restored by implementing measures aimed at providing increased owner oversight of the affairs of the company and particularly of management.[91] The proposals set forth above would provide this type of owner oversight while still leaving management the flexibility needed to effectively run these companies. The current nature of the securities laws operate to stifle shareholder oversight and action. These rightful stakeholders should be given a voice beyond the one that they now have as a result of the current securities regime, which is "voicing" their opinion merely through electing to sell their shares. It might even be said that the current climate of low public confidence in the market is brought about both by management's lack of accountability to owners and the owner's refusal to get involved for fear of becoming entangled in the web of securities restrictions and/or incurring liabilities.

A reform of the insider trading regime as suggested above would greatly reduce the reasons that owners currently have for avoiding any probes into managerial activities. "Trading plans" could be filed with the issuer and the "notice of trading plan" publicly filed allows oversight shareholders to prearrange trades without fears of either being prohibited from making desired trades or later being determined to have violated insider trading prohibitions. Their acquisition of material nonpublic information would no longer carry with it the spector of liability. Management would then be forced to keep the interests of the shareholders at the forefront of their minds when deciding important company issues and to

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[91] *See supra* Parts II.B, III.B and IV.B.

otherwise be more accountable to the shareholders/owners.

The current proxy system, while having certain restricted means allowing shareholders to communicate, does not allow wide-scale communication without uncertainty or without first going through the cumbersome and often cost-prohibitive processes dictated by the proxy rules. The safe harbor suggested here would allow beneficial communications and still preserve the policy behind the proxy rules—encouraging a system where shareholders are informed about issues upon which they will exercise their rights of corporate suffrage and preventing undue influence with respect to votes. Under the recommended safe harbor, however, the proxy rules would remain, but only become triggered with respect to oversight shareholders once there is an actual solicitation of a proxy on a particular issue, and therefore, such rules would not operate to curtail what should be considered a natural right of these oversight shareholders—to communicate with other oversight shareholders, with management and board members. Relaxing the restrictions on shareholder communication will foster more owner involvement and result in accountability to owners by management.

Passing legislation that clarifies and unifies the laws defining and governing "control persons" and providing clear guidance to shareholders on the applicability of these laws to them, and thus eliminating possible exposure to liability under Section 20(a) of the Act for the actions of another party, would go a long way toward increasing owner oversight in the affairs of a public company. Requiring public companies to open their board, audit, and compensation committee meetings and providing informational packages to oversight shareholders would also help to achieve greater owner oversight and accountability to shareholders. Currently, investors face a great deal of uncertainty in the applicability of the law and consequently are forced to take an extremely conservative approach when probing into management's affairs, especially with respect to insisting that changes be made. Shareholders, as a result, are forced again to merely voice their concerns by taking the safe approach of choosing whether to retain or sell their investment. Such passivity should be replaced by means through which owners can act like real owners and suggest certain changes in management or company policy, which cannot realistically be expected to take place until shareholders can obtain some relative certainty regarding their exposure to liability as a result of taking actions.