Shareholder Primacy and the Business Judgment Rule: Arguments for Expanded Corporate Democracy

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Abstract

There is a fundamental flaw in the law's approach to corporate governance. While shareholder primacy is a well-established norm within United States corporate law, the business judgment rule essentially holds directors blameless when they fail to maximize shareholder wealth. During the past century, control of the corporation has shifted from shareholders to managers. As a result, shareholders have little practical say in who runs the corporation, and they cannot usually hold managers legally liable when those managers destroy shareholder wealth through incompetence. Despite a number of arguments asserting that shareholders do not deserve any additional management powers, this article concludes that this flaw in corporate governance compels greater shareholder democracy, primarily through access to the corporate proxy to nominate directors.

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Abstract........................................................................................................................................1
Introduction......................................................................................................................................3
I. The Corporate Governance Conundrum ..........................................................................................4
   A. The Shareholder Primacy Norm ............................................................4
   B. The Business Judgment Rule ........................................................................8
      1. A Brief History of the Business Judgment Rule ...................................8
      2. Recent Applications of the Business Judgment Rule ......................14
      3. The Strength of the Business Judgment Rule .................................15
   C. The Business Judgment Rule and Shareholder Primacy .....................17
II. Shareholder Power in Controlling the Corporation .................................................................18
   A. Shareholder Proxy Access .................................................................19
   B. Arguments Against Shareholder Proxy Access ..................................23
      1. Proxy Access is Unnecessary .....................................................23
      2. Economic Stability ....................................................................24
      3. Corporate Performance ..........................................................25
      4. Fairness and Democracy ..........................................................26
      5. Corporate Social Responsibility ..............................................27
      6. Federalism ...................................................................................28
      7. Workability ................................................................................29
      8. Alternatives ................................................................................30
   C. Arguments in Favor of Shareholder Proxy Access ........................................29
      1. Fairness and Democracy ............................................................30
      2. Accountability and Corporate Performance ................................31
      3. Economic Stability .....................................................................33
   D. Answers to Objections to Shareholder Proxy Access ........................................33
      1. Empowering Institutional Investors and Other Special Interests ..........34
      2. Corporate Waste ..........................................................................34
         i. Shareholder Apathy ...............................................................35
         ii. Board Cohesion ....................................................................35
         iii. Proxy Contests ....................................................................36
      3. Short-Term Decision Making .....................................................36
      4. Corporate Social Responsibility ..............................................37
III. Shareholder Primacy and the Business Judgment Rule Together Require More Shareholder Democracy .................................................................38
IV. Conclusion ..............................................................................................................................41
Introduction

There is a fundamental flaw in the law’s approach to corporate governance: shareholder primacy is a well-established norm within United States corporate law.\(^1\) Put simply, the majority view holds that the principal role of the corporation is to maximize the wealth of its shareholders.\(^2\) Within corporations, the “locus of power is the board of directors.”\(^3\) But under the business judgment rule, shareholders are often left with no legal recourse when their directors fail to maximize shareholder wealth.\(^4\)

Shareholders have only two practical options when directors fail to maximize shareholder wealth: sell their shares\(^5\) or remove the directors.\(^6\) The first option is of little value if shareholders have already lost a substantial amount of their investment.\(^7\) The second option, as discussed in this article, has not been available for

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3 Hayden & Bodie, supra note 1, at 2078; see, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2010) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .”); MODEL BUS. CORP. ACT § 8.01(b) (2009) (“All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors . . . .”).

4 Courts do not second-guess the substance of a board decision that leads to a corporate loss “apart from consideration of the good faith or rationality of the process employed.” In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996); accord In re Citigroup, 964 A.2d at 122, In re The Dow Chem. Co. Derivative Litig., No. 4349, 2010 Del. Ch. LEXIS 2, at *37 n.55 (Del. Ch. Jan. 11, 2010).

5 This strategy is sometimes referred to as the “Wall Street Walk.” See, e.g., Constance A. Bagley & Karen L. Page, The Devil Made Me Do It: Replacing Corporate Directors’ Veil of Secrecy with the Mantle of Stewardship, 36 SAN DIEGO L. REV. 897, 909 (1999) (describing the “Wall Street Walk” from an ethical standpoint—i.e., if a company’s actions do not comport with a shareholder’s ethical values, the shareholder can sell that company’s stock and buy stock in another company that better exemplifies the shareholder’s ethical values); Ending the Wall Street Walk: Why Corporate Governance Now? (Commentary), CORP. GOV., http://www.corpgov.net/forums/commentary/ending.html (last visited Aug. 14, 2010).

6 See, e.g., DEL. CODE ANN. tit. 8, §§ 141(k), 211(b) (2010); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (Del. 1985) (“If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out.” (citing Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984))).

7 For example, a group of Citigroup shareholders sued its directors alleging one reason Citigroup’s share price dropped below its book value in 2008 was due to the directors failing to properly monitor the risks incurred by Citigroup in the sub-prime mortgage market. In re Citigroup, 964 A.2d at 111, 114. Some shareholders take umbrage at the notion that if they
most shareholders. But granting shareholders the means to more actively participate in the selection of directors is the most practical option shareholders have to protect their interests.

This Article initially examines a corporate governance conundrum arising from the interplay between the shareholder primacy norm and the business judgment rule. First, the history of the shareholder primacy norm is reviewed, demonstrating that it remains a core principle guiding corporate governance. The development of the business judgment rule is then reviewed, concluding with recent applications of the rule establishing it as the standard approach courts take with regard to director liability. The corporate governance conundrum—and flaw—lies in the fact that, due to the business judgment rule, shareholders have minimal legal recourse when directors fail to maximize shareholder wealth.

This leads next to an examination of the concept of shareholder democracy—an approach to empower shareholders primarily by allowing them access to the corporate proxy to nominate directors. This part of the article examines the arguments against shareholder democracy and then examines its advantages and counters many of its criticisms. This article then moves beyond most shareholder democracy arguments by returning to the corporate governance conundrum examined earlier to present a case for why the combination of the shareholder primacy doctrine and the business judgment rule provides the strongest argument yet presented for why shareholders should be provided greater democracy.8

I. The Corporate Governance Conundrum

A. The Shareholder Primacy Norm

Under the shareholder primacy norm, corporate managers should only make decisions for the benefit of those who own shares of the corporation.9 Shareholder

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8 This article focuses on rights of shareholders and liabilities of directors of large, publicly traded corporations. Most of the issues presented in this article do not apply to closely held corporations in which the majority, if not all, of the shareholders are active in the management of the corporation. In addition, Delaware corporate law is predominantly cited, as Delaware is the home of a majority of large, publicly traded corporations (see infra note 18) and Delaware is considered to be the most popular state for incorporation (see S. Samuel Arsht, A History of Delaware Corporation Law, 1 DEL. J. CORP. L. 1, 1 (1976)).

9 Adolph A. Berle, Jr., Corporate Powers as Powers in Trust, 44 HARV. L. REV. 1049, 1049 (1931) (arguing all powers granted to a corporation or its managers are exercisable only for the benefit of the shareholders); Theodore Levitt, The Dangers of Social Responsibility, 36 HARV. BUS.
Shareholder primacy and the Business Judgment Rule

Shareholder primacy is reflected in the axiom that the sole purpose of the corporation is to maximize profits, or more specifically that management’s objective is to maximize shareholder wealth. The foundation of the shareholder primacy norm is the directors’ fiduciary duty to make decisions that are in the best interests of the shareholders.

Shareholder primacy may arguably be traced back to the classic case of Dodge v. Ford Motor Co. In Dodge, shareholders sued the Ford Motor Company for using surplus earnings to cut the price of its automobiles rather than pay dividends. Concluding that corporations are organized and operated primarily for the profit of the stockholders, the Michigan Supreme Court held “the powers of the directors are to be employed for that end.” Shareholder primacy remains the dominant force in corporate governance, particularly in Delaware, where a majority of the largest publicly-held corporations are incorporated.

Lyman Johnson refers to the

REV. 41, 49 (Sept.-Oct. 1958) (“Business will have a much better chance of surviving if there is no nonsense about its goals—that is, if long-run profit maximization is the one dominant objective in practice as well as in theory.”).

Milton Friedman, Capitalism and Freedom 133 (2d ed. 1963) (“[T]here is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud.”).


D. Gordon Smith, The Shareholder Primacy Norm, 23 J. Corp. L. 277, 278 (1998); see also Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986) (holding that a board may consider stakeholder interests in attempting to prevent a hostile takeover, but has a fiduciary duty to act in the stockholders’ best interests); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (“Corporate directors have a fiduciary duty to act in the best interests of the corporation’s stockholders.”).


Dodge, 170 N.W. at 683.

Id. at 684. The Michigan Supreme Court also held that when the directors act for the “incidental benefit of shareholders and for the primary purpose of benefiting others,” that is the point at which a court has a duty to interfere. Id. The court upheld the lower court’s decree specifying an amount to be distributed to shareholders as dividends. Id. at 685.

Bainbridge, supra note 1, at 1423 (“Shareholder wealth maximization long has been the fundamental norm which guides U.S. corporate decisionmakers.”); David Millon, Communitarians, Contractarians, and the Crisis in Corporate Law, 50 Wash. & Lee L. Rev. 1373, 1374 (1993) (“[S]hareholder primacy has served as corporate law’s governing norm for much of this century.”); Springer, supra note 13, at 88 (“At the end of the day, it appears that the shareholder primacy norm has been relatively unchallenged throughout much of the Twentieth Century.”).

See Bainbridge, supra note 1, at 1424.

shareholder primacy norm as "the supreme purpose of corporate activity, a purpose privileged above all others." Proponents of the shareholder primacy norm argue that maximizing shareholder wealth is in the best interests of society.

Additionally, courts initially viewed corporate directors as trustees and shareholders as the beneficiaries of that trust. The United States Supreme Court extended the trust metaphor to shareholder value in *Dodge v. Woolsey,* holding that courts in equity have jurisdiction over corporations:

> to prevent any misapplication of their capitals or profits, which might result in lessening the dividends of stockholders, or the value of their shares, as either may be protected by the franchises of a corporation, if the acts intended to be done create what is in the law denominated a breach of trust.

*Dodge v. Woolsey* addressed a situation in which a shareholder of a bank filed suit to enjoin the imposition of a new state tax after the directors of the bank refused to file a similar suit. The Supreme Court considered the directors' refusal to contest the tax more than a mere error in judgment, but a disregard of their duty amounting to a breach of trust—an illegal application of the profits due to the stockholders of the bank. *Dodge v. Woolsey* set in motion a series of cases upholding the right of shareholders to initiate actions to protect their investments when directors failed to do so, but only when the shareholders faced irreparable loss, demonstrating a

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20 Hayden & Bodie, *supra* note 1, at 2082; see also Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 38 (1996) (arguing that a successful firm provides jobs for workers and better products and services for consumers, and that prosperity for stockholders, workers and communities goes hand in hand); Smith, *supra* note 12, at 291 (arguing that theoretical justifications for shareholder primacy arose, in part, from the purposes of early corporations themselves—to serve the public interest).

21 See, e.g., *Gray v. President,* 3 Mass. (3 Tyng) 364, 379 (1807) ("[T]he corporation is the trustee for the management of the property, and each stockholder a cestui que trust according to his interest and shares . . ."); Butts v. Wood, 37 N.Y. 317, 318 (1867) (holding the relationship between a director and a corporation is that of trustee and cestui que trust); Robinson v. Smith, 3 Paige Ch. 222, 232 (N.Y. Ch. 1832) ("[D]irectors are the trustees or managing partners, and the stockholders are the cestui que trusts . . ."); Verplanck v. Mercantile Ins. Co. of N.Y., 1 Edw. Ch. 84, 87 (N.Y. Ch. 1831) ("[W]hen a corporation aggregate is formed, and the persons composing it . . . place the management and control of its affairs in the hands of a select few . . . then such directors become the agents and trustees of the corporators . . ."); Hodges v. New England Screw Co., 1 R.I. 312, 340 (1850) (holding the directors of a corporation "liable in equity, as trustees, for a fraudulent breach of trust.").

22 59 U.S. 331 (1855).

23 *Id.* at 341.

24 *Id.* at 336-39.

25 *Id.* at 345. Woolsey, the plaintiff shareholder, claimed "the tax is so onerous upon the bank, that it will compel a suspension and final cessation of its business." *Id.* at 339.

26 See, e.g., *Detroit v. Dean,* 106 U.S. 537, 541-42 (1883); *Norman v. Consol. Edison Co. of N.Y.,* 89 F.2d 619, 622-24 (2d Cir. 1937) (reviewing Supreme Court cases addressing the
propensity on the part of the courts to protect shareholder value.

The court’s goal of protecting shareholder value also served to protect minority shareholders from abuses by majority shareholders who controlled the board.\textsuperscript{27} In fact, D. Gordon Smith argues that \textit{Dodge v. Ford Motor Co.} is no more than a minority shareholder oppression case and the court’s shareholder primacy holding merely followed a long line of minority shareholder oppression precedent. This helps to explain why the court made its “shareholder primacy” pronouncement without citation to authority: it was instead relying on precedent from minority shareholder oppression cases.\textsuperscript{28}

But recent anecdotal evidence suggests the shareholder primacy norm does not protect society at large, nor shareholders in particular.\textsuperscript{29} For example, the court-appointed examiner for the Lehman Brothers Holdings Inc. bankruptcy reported that in 2006, “Lehman made the deliberate decision to embark upon an aggressive growth strategy, to take on significantly greater risk, and to substantially increase leverage on its capital[,]”\textsuperscript{30} which included substantial investments in sub-prime mortgage-related securities. As the sub-prime mortgage market morphed into a financial crisis in 2007, rather than pare its losses, Lehman consciously chose to “‘double down’, hoping to profit from a counter-cyclical strategy.”\textsuperscript{31} In 2008, it became apparent Lehman’s growth strategy was flawed,\textsuperscript{32} and its fidelity to shareholder primacy resulted in the company filing Chapter 11 bankruptcy, the largest U.S. bankruptcy ever filed.\textsuperscript{33} Citigroup suffered a similar fate, though not as severe as bankruptcy, when its management also chose to invest in sub-prime mortgage-related securities, causing, in part, the corporation’s stock price to drop below its book value in 2008.\textsuperscript{34} The sub-prime mortgage crisis, which precipitated a global financial crisis,\textsuperscript{35} led to

ability of shareholders to bring actions when faced with irreparable harm).

\textsuperscript{27} See, e.g., Tower Hill-Connellsville Coke Co. of W. Va. v. Piedmont Coal Co., 64 F.2d 817, 826 (4th Cir. 1933) (holding majority shareholders become the corporation, and, as such, assume the trust relation occupied by the corporation towards its stockholders and may not impair the value of the minority shareholders’ interest).

\textsuperscript{28} Smith, \textit{supra} note 12, at 319-20; see also \textit{supra} notes 13-15 and accompanying text (discussing \textit{Dodge v. Ford Motor Co.}). But see Johnson, \textit{supra} note 19, at 874 n.41 (using \textit{Dodge v. Ford Motor Co.} as an example of a court asserting a “self-evident proposition”).

\textsuperscript{29} For a discussion of the interplay between directors’ fiduciary duties and the role of the corporation in society during economic crises, see Robert J. Rhee, \textit{Fiduciary Exemption for Public Necessity: Shareholder Profit, Public Good, and the Hobson’s Choice During a National Crisis}, 17 \textit{GEO. MASON L. REV.} 661 (2010).

\textsuperscript{30} \textit{In re} Lehman Bros. Holdings Inc., No. 08-13555 (JMP) at 4 (Bankr. S.D.N.Y. Mar. 11, 2010) (footnote omitted).

\textsuperscript{31} \textit{Id.} (footnote omitted).

\textsuperscript{32} \textit{Id.}

\textsuperscript{33} \textit{Id.} at 2.

\textsuperscript{34} \textit{In re} Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106, 114 (Del. Ch. 2009).


\textit{Fall 2010 Shareholder Primacy and the Business Judgment Rule 7}
multi-trillion dollar government bailouts and guarantees. In the opinion of one commentator, "[t]here's no other way of saying it: today's doctrines of shareholder primacy and managerial self-interest have brought many companies to the brink of self-destruction."

The shareholder primacy norm is also bolstered by the business judgment rule. Regardless of how seemingly "stupid," "egregious" or "irrational" a board decision may be that destroys, rather than maximizes, shareholder wealth, it "provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests."

B. The Business Judgment Rule

To further bolster the shareholder primacy norm, courts—particularly Delaware courts—have enforced the business judgment rule. Scholars argue that "[w]ealth is maximized when corporations are run by directors who know that their decisions will be reviewed by investors, by analysts, by stockholders, and by business partners—but not by the courts."

1. A Brief History of the Business Judgment Rule

The first reported case in the United States addressing the duty of care of directors is from the Louisiana Supreme Court in Percy v. Millaudon, decided in 1829. In Percy, shareholders of the Planters' Bank sued three of its directors for losses allegedly resulting from improper loans to the Bank's president and cashier.


Simon Caulkin, Corporate Apocalypse, MGMT. TODAY, Jan. 1, 2009, at 50, 52. See also OECD, The Corporate Governance Lessons from the Financial Crisis (2009), available at http://www.oecd.org/dataoecd/32/1/42229620.pdf ("[T]he financial crisis can be attributed to failures and weaknesses in corporate governance arrangements... '").


David Rosenberg, Galactic Stupidity and the Business Judgment Rule, 32 J. CORP. L. 301, 303 (2007). This same sentiment was echoed by the Delaware Court of Chancery—when directors make poor decisions, redress "must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court." In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005), aff'd, 906 A.2d 27 (Del. 2006).

Percy v. Millaudon, 8 Mart. (n.s.) 68, 68-69 (La. 1829).
Percy court considered the directors “the agents or mandatories of the stockholders” and focused its analysis on the duties of an agent in the given circumstances. In particular, the Louisiana Supreme Court noted that bank directors are not expected to devote their entire time and attention to the institution, in contrast to those who may be compensated for their time devoted to the bank. Ultimately, the Percy court found no liability because there was no proof of harm to the bank resulting from the directors’ actions.

In 1872, the Pennsylvania Supreme Court addressed the broad question of whether “the directors of a corporation can be made to account for losses arising from mismanagement merely.” Rather than considering directors trustees, the Spering’s Appeal court recognized them as stockholders as well and described them as “mandataries — persons who have gratuitously undertaken to perform certain duties, and who are therefore bound to apply ordinary skill and diligence, but no more.” Spering’s Appeal contains the first reported comprehensive analysis of director liability, concluding:

While directors are personally responsible to the stockholders for any losses resulting from fraud, embezzlement or wilful misconduct or breach of trust for their own benefit and not for the benefit of the stockholders, for gross inattention and negligence

41 Id. at 73. The court was most likely referring to mandataries, persons to whom a legal mandate is given. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1373 (1965).
42 Percy, 8 Mart. (n.s.) at 74.
43 Id. at 75.
44 Id. at 79-80 (noting, though, that if proof of a loss had been sustained, the directors would have been liable).
45 Spering’s Appeal, 71 Pa. 11, 20 (1872). The Pennsylvania Supreme Court did briefly address director liability earlier in Bank of Washington v. Barrington, 2 Pen. & W. 27 (Pa. 1830), in which a bank temporarily lost its incorporation due to a cashier failing to make required payments to the state Treasurer. “The directors were bound not only to know the law, but to take all proper precautions; and if they failed to do so, the consequences are attributable to them . . . .” Id. at 48.
46 Spering’s Appeal, 71 Pa. at 21. “[G]entlemen elected by the stockholders from their own body ought not to be judged by the same strict standard as the agent or trustee of a private estate. Were such a rule applied, no gentlemen of character and responsibility would be found willing to accept such places.” Id. The fact that directors were stockholders who served without compensation was also noted earlier by the Rhode Island Supreme Court in 1850, which held that it would be unjust to hold directors liable for innocent mistakes. Hodges v. New England Screw Co., 1 R.I. 312, 348 (1850) (“The law requires of [directors] care and discretion, such as a man of ordinary prudence exercises in his own affairs; and if they practice this, and nevertheless make a mistake, the law does not hold them answerable.”). The U.S. Supreme Court regarded corporate directors in a similar light, as unpaid “gentlemen” selected from the body of stockholders, who also should not be held accountable short of fraud. Briggs v. Spaulding, 141 U.S. 132, 149 (1891). Briggs v. Spaulding also reflected the current sentiment in English jurisprudence, that too high of a threat of liability would deter “all men of property” from becoming directors. Id. (quoting In re Forest of Dean Coal Mining Co., 10 Ch. D. 450, 451); see also Frederick Dwight, Liability of Corporate Directors, 17 YALE L.J. 33, 36 (1907).
by which such fraud or misconduct has been perpetrated by agents, officers or co-directors, yet they are not liable for mistakes of judgment, even though they may be so gross as to appear to us absurd and ridiculous, provided they are honest and provided they are fairly within the scope of the powers and discretion confided to the managing body.\footnote{Spering's Appeal, 71 Pa. at 24.}

New York preceded Delaware in formalizing a business judgment rule.\footnote{The first reported instance of a U.S. court referring to a “business judgment rule” is in Maroney v. Applegate, 266 A.D. 412, 422, (N.Y. App. Div. 1943) (holding if the directors showed they were guided by the financial necessities of the situation, and not by any ulterior motive, and were attempting to serve faithfully the interests of their company, they should be protected in their actions and decisions). See also Weinberger v. Quinn, 264 A.D. 405, 408 (N.Y. App. Div. 1942) (“[The courts do not pass on or assume to pass on questions of mere business judgment or expediency. Facts showing bad faith or other breach of duty must be alleged before a court will interfere.”) (citation omitted).}

By 1944, New York courts had formally adopted the business judgment rule, holding that absent a showing of fraud or self-interest, management's decisions would not be reviewed by the court, regardless of how unwise those decisions might be.\footnote{Bayer v. Beran, 49 N.Y.S.2d 2, 6 (N.Y. Sp. Term 1944).} Although directors were given wide latitude in the management of the affairs of a corporation, it was also assumed their judgment would be honest, unbiased, and reasonably exercised.\footnote{Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (N.Y. Sp. Term 1944).}

While the Delaware courts did not formally recognize the business judgment rule, per se, until 1960, they did demonstrate respect for business judgment beginning in the early twentieth century.\footnote{See, e.g., Whitmer v. William Whitmer & Sons, Inc., 99 A. 428, 431 (Del. Ch. 1916) (holding a past error in business judgment did not support the appointment of a receiver); Scully v. Auto. Fin. Co., 101 A. 908, 909 (Del. Ch. 1917) (holding transfer of common stock in exchange for a valueless business idea illegal because it was supported by “no pretended exercise of business judgment” by the directors); Atlantic Refining Co. v. Hodgman, 13 F.2d 781, 788 (3d Cir. 1926) (holding the sale of the same issue of stock at different prices to different persons will be sustained if based on the exercise of fair business judgment) (applying Delaware law).} Early attributes of the business judgment
rule first began to appear in Delaware in 1924. In Robinson v. Pittsburgh Refining Corp.,\textsuperscript{52} the corporation’s directors were authorized by a shareholder resolution to entertain bids to sell the assets of the corporation. When the directors’ decision to accept one bid over another was challenged, the Delaware Court of Chancery enunciated three of the basic premises of the modern business judgment rule: (1) it will be presumed the directors acted in the best interests of the corporation;\textsuperscript{53} (2) the terms of the transaction must be so manifestly unfair as to overcome this presumption;\textsuperscript{54} such that (3) the directors’ “action was so unreasonable as to be removed entirely from the realm of the exercise of honest and sound business judgment.”\textsuperscript{55} As the Delaware Supreme Court explained as early as 1927, “an honest mistake of business judgment should not be reviewable by the Court.”\textsuperscript{56} By the mid-1940s it had become established law in Delaware that directors would not be liable for “mere mistakes.”\textsuperscript{57} The business judgment rule was formally adopted in Delaware in 1960 when the Delaware Supreme Court refused to substitute its “uninformed opinion for that of experienced business managers of a corporation who have no personal interest in the outcome . . .” of the adoption of a corporate plan.\textsuperscript{58}

\textsuperscript{52} Robinson v. Pittsburgh Oil Refining Corp., 126 A. 46 (Del. Ch. 1924).
\textsuperscript{53} Id. at 48.
\textsuperscript{54} Id.
\textsuperscript{55} Id. at 49.
\textsuperscript{56} Bodell v. Gen. Gas & Elec. Corp., 140 A. 264, 267 (Del. 1927) (holding the discretion of directors in their selling stock “should not be interfered with, except for fraud, actual or constructive, such as improper motive or personal gain or arbitrary action or conscious disregard of the interests of the corporation and the rights of its stockholders.”).
\textsuperscript{57} Perrine v. Pennroad Corp., 47 A.2d 479 (Del. 1946), cert. denied, 329 U.S. 808.

In the settlement of disputes in which corporations are interested, the Directors of the Corporation, who are its duly accredited managers, are called upon to exercise honest business discretion. If it appears that they acted honestly, they are not responsible for mere mistakes, and under such circumstances Courts will not interfere with their action or attempt to assume their authority to act. This must necessarily be so, otherwise, the Courts will be called upon to settle many business disagreements between the stockholders of corporations, which should be disposed of by the Directors who, as a general rule, are chosen by a majority of the stockholders for that purpose.

\textsuperscript{58} Beard v. Elster, 160 A.2d 731, 738-39 (Del. 1960) (holding a stock option plan, which allowed for exercising of options only while an optionee was employed by the company, was valid as adopted by an independent and disinterested board of directors). There were earlier indirect references to the business judgment rule by Delaware courts. For example, in Nadler v. Bethlehem Steel Corp., 154 A.2d 146, 149 (Del. Ch. 1959), the Delaware Court of Chancery stated that executive compensation plans fell within the “business judgment rule” (citing Lieberman v. Koppers Co., Inc., 149 A.2d 756, 759 (Del. Ch. 1959) (noting the adoption of a stock distribution plan by the directors was an exercise in their best business judgment). See also Gottlieb v. Heyden Chemical Corp., 90 A.2d 660, 663 (Del. 1952) (refusing to defer to the “sound business judgment of the directors” where a majority of the directors were conferring benefits upon themselves out of the assets of the corporation).
The business judgment rule was further strengthened during the hostile takeover boom in the 1970s and 1980s. Although hostile takeovers experienced massive growth during those two decades, they were a concrete manifestation of an idea from the 1960s. It was during that previous decade that Robin Marris, a professor of economics, argued that inefficient input and output markets could be fixed by a third corporate control market. In theory, such a market would allow outside interests to redirect firms, forcing managers to make decisions that maximize shareholder profits. In the 1960's unsolicited takeover offers increased in number and exploded in the 1980s, becoming quite controversial. Many critics from traditional corporate backgrounds viewed corporate raiders as arrogant and regarded them with suspicion. The public was generally hostile to corporate takeovers, largely because of negative media attention and their frequently negative local impact. Junk bond-financed hostile takeovers threatened to shake up the corporate world, and, as such, gave rise to considerable resistance from corporate boards and directors. Many corporate directors viewed takeovers as a threat to their power, largely because takeovers were often followed by the firing of corporate managers. As a result, managers began to develop a wide array of self-help measures designed to thwart takeovers.

These self-help defense tactics posed new problems for corporate governance because they may have conflicted with boards' and managers' fiduciary duty to

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61 Scherer, supra note 59, at 69-70.
62 Id.
64 Carol B. Swanson, The Turn in Takeovers: A Study in Public Appeasement and Unstoppable Capitalism, 30 GA. L. REV. 943, 969 (1996) (noting the public's perception of popular books and movies on the subject of takeovers and the negative effects that takeovers had on labor).
66 Springer, supra note 13, at 92-94.
67 Id. at 94; Jeffrey N. Gordon, Corporations, Markets, and Courts, 91 COLUM. L. REV. 1931, 1938-39 n.21 (1991) (explaining defensive measures, including the poison pill and the flip-over); Jeffrey N. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett, 19 CARDOZO L. REV. 511, 511-13 (1997) (discussing poison pills, deadhand pills, and corporate bylaws); Swanson, supra note 64, at 977 (discussing poison pills, shark repellent amendments, and studies showing the negative economic effects of such mechanisms).
maximize shareholder profits.\textsuperscript{68} There is a risk that corporate directors may act in their own interests, rather than those of their corporations' shareholders, in resisting hostile takeovers.\textsuperscript{69} A line of court decisions addressed the problem by applying a modified business judgment rule, allowing corporate directors to make decisions pursuant to their best judgment, provided they met their initial burden of showing that their decisions were reasonable and proportional.\textsuperscript{70} Delaware courts began to require corporate directors to meet two conditions before they would apply the business judgment rule to director reactions to takeover attempts: (1) corporate directors must show they possessed a reasonable belief in "a danger to corporate policy and effectiveness[;]" and (2) their reaction was "reasonable in relation to the threat posed."\textsuperscript{71} Once those conditions were met, courts presumed corporate directors acted in good faith in the best interests of the shareholders and would not second-guess those decisions.\textsuperscript{72} If corporate directors could demonstrate a reasonable belief that a tender offer posed a threat to the corporation and that they took reasonable steps in responding to it, they could take self-help measures, such as using poison pills, without violating their fiduciary duty to corporate shareholders.\textsuperscript{73} Once directors earn protection under the business judgment rule, plaintiffs have the burden of showing that directors breached their fiduciary duty or prioritized their own interests over those of the corporation.\textsuperscript{74}

The situation came to a head at the close of the 1980s, when the Supreme Court of Delaware rendered its \textit{Paramount} decision.\textsuperscript{75} Near the closing of a complicated merger between Time, Inc. and Warner Communications, Paramount Communications announced an all-cash offer to purchase Time's outstanding shares.\textsuperscript{76} After negotiations, Time's board decided to refuse Paramount's tender offer and to continue with its merger with Warner.\textsuperscript{77} Although Paramount offered a valuable cash premium, Time directors expressed concerns that the company's shareholders did not understand the long-term benefits of the Warner merger,

\textsuperscript{68} Swanson, \textit{supra} note 64, at 978.


\textsuperscript{70} Swanson, \textit{supra} note 64, at 978.

\textsuperscript{71} BNS \textit{Inc., 683 F. Supp. at 473-74; Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180, 182 (Del. 1986) (applying the business judgment rule to Revlon's attempt to block a hostile takeover by Pantry Pride and allowing directors to consider non-shareholder constituencies if "there are rationally related benefits accruing to the stockholders[;]"); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954, 955 (Del. 1985) (applying the business judgment rule and imposing the two conditions on Unocal's attempt to resist a tender offer by Mesa Petroleum).


\textsuperscript{73} BNS, \textit{Inc., 683 F. Supp. at 474.

\textsuperscript{74} Id. at 474 (finding directors' poison pill threat did not breach their fiduciary duty).

\textsuperscript{75} Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989).

\textsuperscript{76} Id. at 1147.

\textsuperscript{77} Id.
including the company’s ability to retain its corporate culture.\textsuperscript{78} Time rejected Paramount’s offer and restructured its merger with Warner as a cash and securities acquisition.\textsuperscript{79} Time’s directors persisted in this move, even after Paramount responded with an increased cash offer.\textsuperscript{80} Subsequently, Paramount and some of Time’s shareholders sued Time.\textsuperscript{81} The Delaware Supreme Court reaffirmed Unocal’s two requirements before applying the business judgment rule and noted that a refusal to accept a cash offer could comply with that rule.\textsuperscript{82} The court found that Time’s directors possessed a reasonable belief that Paramount’s offer presented a threat to the company and acted reasonably in rejecting it.\textsuperscript{83}

2. Recent Applications of the Business Judgment Rule

The 2007-2009 Citigroup shareholder derivative litigation reflects a very recent application of the business judgment rule, applied directly to the current financial crisis.\textsuperscript{84} The Citigroup court summarized the shareholders’ claims as attempting to hold the directors personally liable for making, or allowing business decisions that, in hindsight, turned out poorly for the company.\textsuperscript{85} According to the court this type of decision-making falls within the business judgment rule: "a presumption 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."\textsuperscript{86} The burden is on the shareholders who are challenging the directors' decision to rebut this presumption.\textsuperscript{87} In dismissing the plaintiffs' complaint, the court stated that "absent an allegation of [self-] interestedness or disloyalty to the corporation, the business judgment rule prevents a judge or jury from second guessing director decisions if they were the product of a rational process and the directors availed themselves of all material and reasonably available information."\textsuperscript{88}

The Citigroup court repeated the rationale of the business judgment rule: "discretion granted [corporate] directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that

\textsuperscript{78} Id. at 1148.
\textsuperscript{79} Id.
\textsuperscript{80} Id. at 1149.
\textsuperscript{81} Id.
\textsuperscript{82} Id. at 1152.
\textsuperscript{83} Id. at 1153-55.
\textsuperscript{84} In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009).
\textsuperscript{85} Id. at 124.
\textsuperscript{86} Id. (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)) (internal quotation marks omitted).
\textsuperscript{87} Id.
\textsuperscript{88} Id.; see also Gantler v. Stephens, 965 A.2d 695, 705-06 (Del. 2009) (holding same).
they will be held personally liable if the company experiences losses." The next year, in *In re Dow Chemical Company Derivative Litigation*, the Delaware Chancery Court emphasized that a court may only review the decision-making method of the board. The substance of the board’s decision, on the other hand, is unreviewable under the business judgment rule.

In the 2009 case *Lyondell Chemical Co. v. Ryan*, the Delaware Supreme Court examined in detail the good faith requirement under the business judgment rule. *Lyondell* presents an additional factor associated with the business judgment rule—Delaware’s General Corporation Law permits corporations to include in their charter an exculpatory provision protecting directors from personal liability for breaches of the duty of care. If the corporation has adopted such an exculpatory clause, plaintiffs, like those in *Lyondell*, must allege that the directors breached their duty of loyalty, which cannot be exculpated. To establish a breach of loyalty, plaintiffs must prove the directors failed to act in good faith.

Directors’ failure to act in good faith is most typically shown by: (1) intentional acts with a purpose other than that of advancing the best interests of the corporation; (2) intentional violations of applicable law; or (3) intentionally failing to act in the face of a known duty to act, demonstrating a conscious disregard for their duties. The standard adopted by the Delaware courts is that directors’ decisions need not be perfect, merely reasonable. But unreasonableness requires a conscious disregard of duties. Stated another way, “In the transactional context, a very extreme set of facts would seem to be required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties.”

3. The Strength of the Business Judgment Rule

From the earliest days of the corporation, courts have demonstrated a reluctance to hold directors accountable for anything less than gross negligence or

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89 *In re Citigroup*, 964 A.2d at 139.
91 Id. at *37 ("[S]ubstantive second-guessing of the merits of a business decision... is precisely the kind of inquiry that the business judgment rule prohibits.") (citing *In re Citigroup*, 964 A.2d at 122).
92 970 A.2d 235, 239 (Del. 2009) (summarizing the plaintiffs’ claims as alleging the directors failed to obtain the best available price in selling the company).
93 See DEL. CODE ANN. tit. 8, § 102(b)(7) (1999); *Lyondell*, 970 A.2d at 239.
94 *Lyondell*, 970 A.2d at 239.
95 See id. at 239-40.
96 *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006) (citing *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 755 (Del. Ch. 2005)).
97 *Lyondell*, 970 A.2d at 243.
self-dealing. As early as 1907, commentators were beginning to recognize that directors had little to fear from the courts. As of 1992, Carney wrote he could find only five cases in which directors had not been shielded by the business judgment rule, concluding there "is a rule of no liability for breaches of the duty of care."  

Recent Delaware cases emphasize that liability will be found only where the board was not informed or disinterested. For example, in McMullin v. Beran, the Delaware Supreme Court reversed the Chancery Court's granting of the defendants' motions to dismiss, recognizing that the plaintiffs' allegations, if true, suggested that the directors breached their duty of care by approving a merger without adequately informing themselves about the transaction. In Sample v. Morgan, the Delaware Chancery Court denied the defendants' motion to dismiss the shareholder plaintiffs' claims they were materially misled by the board in voting to approve a compensation plan that would unfairly benefit the directors. Finally, in Blackmore Partners, L.P. v. Link Energy LLC, the Delaware Chancery Court held an allegation that the defendant directors' approved sale of substantially all of the company's assets, which exceeded the company's liabilities by $25 million, and a resultant distribution of proceeds that went exclusively to the company's creditors, raised a reasonable inference of disloyalty or intentional misconduct.

99 See, e.g., Dwight, supra note 46, at 34 (noting shareholder safeguards had "become either dead letters or the merest farce["]).

100 William J. Carney, The ALI's Corporate Governance Project: The Death of Property Rights?, 61 GEO. WASH. L. REV. 898, 922 n.126 (1993) (excluding financial institutions); see also Joseph W. Bishop, Jr., Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 YALE L.J. 1078, 1099 (1968) ("The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack."); Stuart R. Cohn, Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule, 62 TEX. L. REV. 591, 591 n.1 (1983) (identifying seven "successful shareholder cases not dominated by elements of fraud or self-dealing["]).

101 765 A.2d 910 (Del. 2000).

102 Id. at 922; see also In re Bridgeport Holdings, Inc., 388 B.R. 548, 569 (Bankr. D. Del. 2008) (denying defendants' motions to dismiss the claims against the directors for breaches of fiduciary duties where the defendants allegedly "approved an uninformed fire-sale of the Company's most valuable assets on the eve of bankruptcy["])(aplying Delaware law); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993) (holding the defendant directors, as a board, breached their duty of care by reaching an uninformed decision to approve the sale of the company).

103 914 A.2d 647 (Del. Ch. 2007); see also Teachers' Retirement Sys. of La. v. Aidinoff, 900 A.2d 654, 675 (Del. Ch. 2006) (denying defendants' motion to dismiss claims alleging self-dealing); In re LNR Property Corp., 896 A.2d 169, 176 (Del. Ch. 2005) (citing Thorpe v. CERBCO, 676 A.2d 436, 443 n.9 (Del. 1996) (holding when a controlling shareholder stands on both sides of a transaction that shareholder has the burden of establishing the entire fairness of the transaction due to the inapplicability of the business judgment rule where self-interest may have colored directors' actions).

104 864 A.2d 80, 86 (Del. Ch. 2004); see also Selheimer v. Manganese Corp. of Am., 423 Pa. 563, 580-81 (Pa. 1966) (implying directors who have been imprudent, wasteful, careless and
C. The Business Judgment Rule and Shareholder Primacy

A significant shortcoming of the shareholder primacy norm, as bolstered by the business judgment rule, is that corporate directors have a plain incentive to maximize short-term profits, possibly at the expense of the long-term viability of the firm. Commentators have argued the shareholder primacy norm has distracted corporations from their substantive business models to instead pursue increasing share prices. For example, in a continual attempt to increase share prices, directors have resorted to share repurchases, restructuring, and reshuffling finances, such as changing inventory valuation methods, accelerating income, deferring expenses and changing pension actuarial assumptions. And when the shareholder primacy norm “backfires,” the business judgment rule can leave the shareholders with no meaningful avenue of recourse.

There is one critical assumption underlying the discretion provided to corporate directors under the business judgment rule—if shareholders are displeased with directors, the shareholders can elect new directors. This replacement power is especially important when director decisions are insulated from judicial review due to the business judgment rule. However, while shareholders elect the directors, they are actually left with little opportunity to actively participate in the director

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106 See, e.g., ROGER LOWENSTEIN, ORIGINS OF THE CRASH: THE GREAT BUBBLE AND ITS UNDOING 7 (2004); MARY O’SULLIVAN, CONTESTS FOR CORPORATE CONTROL 70 (2000) (“[The] alignment of the interests of the strategic managers of US public corporations with the demands of the stock market is now typically regarded as a defining feature of the market-oriented US system of corporate governance.”); Robert H. Hayes & William J. Abernathy, Managing Our Way to Economic Decline, 58 HARV. BUS. REV. 67, 67-68 (July-Aug. 1980) (arguing lower post-WWII productivity growth in the United States, compared to Germany and Japan, was due in part to management’s focus on short-term cost reduction rather than long-term development of technological competitiveness); Michael E. Porter, Capital Disadvantage: America’s Failing Capital Investment System, 70 HARV. BUS. REV. 65, 65 (Sept.-Oct. 1992) (concluding the innovative shortcomings of American businesses were the result of short time horizons, ineffective corporate governance, and high costs of capital—all symptoms of larger problems within the United States’ capital investment system).
108 See, e.g., In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106, 139 (Del. Ch. 2009). (“This doctrine [the business judgment rule] also means, however, that when the company suffers losses, shareholders may not be able to hold the directors personally liable.”).
II. Shareholder Power in Controlling the Corporation

In practice, the shareholders' power to remove and replace directors has proven quite limited, with most directors facing a very low probability of being ousted—largely neutralizing the shareholders' vote as an effective means of ensuring director accountability. As former SEC chairman Arthur Levitt, Jr. stated, "A director has a better chance of being struck by lightning than losing an election." There are three primary reasons shareholder voting power has been diminished: (1) existing boards select the slate of director nominees, and often re-nominate incumbents; (2) director candidates often run unopposed; and (3) most directors are elected by a plurality, rather than a majority. The combination of these factors means the outcome of almost all board elections is a foregone conclusion—incumbent directors win.

Some commentators identify this as a defect in the democratic process of electing boards of directors. They argue that more effective oversight of directors by shareholders is necessary to improve corporate performance and prevent the kinds of scandals and economic crises that rocked the American economy during the past decade.

111 Id. at 688 (concluding that even when shareholder dissatisfaction with board actions and decisions is substantial, the evidence indicates challengers face considerable impediments to replacing boards). See also Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024, 29,026 (June 18, 2009) (proposed rule; to be codified at 17 CFR pts. 200, 232, 240, 249 & 274) ("[A]bsent an effective way for shareholders to exercise rights to nominate and elect directors . . . , the election of directors is a self-sustaining process of the board determining its members, with little actual input from shareholders[,]" leaving directors "effectively unaccountable to shareholders . . . .") (footnote omitted); Rose A. Zukin, Comment, We Talk, You Listen: Should Shareholders' Voices Be Heard or Stifled when Nominating Directors? How the Proposed Shareholder Director Rule Will Contribute to Restoring Proper Corporate Governance, 33 Pepp. L. Rev. 937, 941 (2006).


114 Sjostrom, Jr. & Kim, supra note 112, at 461-62. Sjostrom, Jr. and Kim conclude that despite 52% of S&P 500 and 45% of Fortune 500 corporations adopting majority voting as of February 2007, it has not provided shareholders any effective veto power over director candidates. Id. at 462-63.


A. Shareholder Proxy Access

The principal method of addressing claimed shortcomings in corporate democracy is to provide shareholders with proxy access. Many modern public corporations are owned by a large number of dispersed shareholders, making it difficult for shareholders to attend annual shareholder meetings. This necessitates voting by proxy, whereby shareholders provide written authorization for a “proxy holder” to represent the shareholders and vote their shares at the annual meeting. Information is conveyed to shareholders via a proxy statement, which discloses material information about the corporation.

The Securities and Exchange Act of 1934 gives the Securities and Exchange Commission (SEC) the authority to regulate proxies. The SEC has promulgated rules regulating “when a company must include a shareholder’s proposal in its proxy statement and identify the proposal in its form of proxy when the company holds an annual or special meeting of shareholders.” Rule 14a-8(i)(8), in particular, allows a corporation to exclude a proposal if it “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.” While it is possible for shareholders to wage proxy contests with their own funds and nominate candidates at annual meetings, such campaigns can be expensive and, without access to the proxy statement, most shareholders have few means to effectively threaten incumbents on a board of directors.

The effect of Rule 14a-8(i)(8) has been to prevent shareholder nominations of directors via proxy. Although the SEC has argued that the rationale for this interpretation was to prevent nominators from avoiding election disclosure requirements, the rule has had the effect of solidifying the positions of incumbent

shareholder oversight); supra notes 30-37 and accompanying text.

117 Fairfax, supra note 115, at 1260-61.
119 Id.
120 Id. at 574-75.
122 17 C.F.R. § 240.14a-8.
123 Id. § 240.14a-8(i)(8). The SEC amended Rule 14a-8(i)(8) in 2010 to allow limited shareholder access to the corporate proxy. See infra.
124 Bebchuk, supra note 110, at 688-91 (reviewing proxy-related costs associated with challenging incumbent directors).
Some of shareholders' initial responses to their lack of access to the proxy statement for electoral purposes included "just vote no" and "withhold-the-vote" campaigns. While such strategies had initial success, including instances in which shareholders forced the departure of Disney CEO Michael Eisner and targeted campaigns against Enron auditors, the techniques proved limited. At best, shareholders could force certain directors off of the board, but could not select their replacements.

In response, activist shareholders sought to adopt "bylaws that would open the issuer's proxy to director nominations by shareholders . . . ." In 2004, the American Federation of State, County & Municipal Employees (AFSCME), a public employees' union, offered such an amendment that would have required American International Group, Inc. (AIG) to include shareholder-nominated director candidates in the company's proxy materials. AIG asked the SEC if it could exclude the proposal, and the SEC issued a no-action letter, which led to the AFSCME litigation. AFSCME argued that because it was only proposing to amend the corporate bylaws, its proposal did not relate to a particular election, but to elections in general. The Second Circuit Court of Appeals had to determine whether a shareholder proposal "relates to an election" if it would amend the corporate bylaws to entitle certain shareholders to include their nominees for the board of directors in the corporate proxy materials. The Second Circuit held that the rule's language was ambiguous and that the phrase "relates to an election" could reasonably be interpreted to exclude either election proposals in general or only those related to specific elections. The court noted that the SEC adopted the latter interpretation in its 1976 Statement but had gradually adopted the former interpretation in its 1976 Statement.
interpretation over time. The court found that, while the SEC has considerable discretion to interpret its own regulations and change such interpretations in response to capital markets or simply for a new regulatory approach, it must explain the rationale for any such shift. Since the SEC failed to even proffer an explanation for its changed interpretation, the court held the exclusion only applied to proposals related to particular elections and not to those proposals that "would establish the procedural rules governing elections generally."

AFSCME revived debate about shareholder access to the corporate proxy, and the SEC responded to the decision by recommending that Rule 14a-8 be amended regarding shareholder nomination of directors. The SEC considered two proposals: an "Access Proposal," which would provide qualified shareholders with access to company proxy materials to nominate directors, and a "Non-Access Proposal," which would foreclose shareholder proxy access to nominate directors through bylaw amendments. After examining the two proposals through the rulemaking process, the SEC voted to adopt the Non-Access Proposal.

But this did not end the debate over shareholder access to proxy materials for the purpose of nominating directors. In 2009, the SEC proposed rule amendments that "would provide shareholders with a meaningful ability to exercise their state law rights to nominate the directors of the companies that they own." Section 971 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law July 21, 2010, authorizes the SEC to promulgate rules permitting shareholders to use company proxy solicitation materials for the purpose of nominating individuals to the company's board of directors, under such terms and conditions as the Commission determines are in the interests of shareholders and for the protection of investors. Shortly thereafter, the SEC issued a final rule amending its proxy rules

137 AFSCME, 462 F.3d at 127-29.
138 Id. at 129.
139 Id. at 129-30.
142 Id.; Brown, supra note 140, at 1369-72.
to facilitate shareholder director nominations. The new SEC rule 14a-11 requires companies to include in their proxy statements the names of directors nominated by shareholders, provided the nominating shareholder or group of shareholders have owned at least 3% of the company’s voting shares for at least three years. The company is not required to include more than one shareholder nominee or nominees in excess of 25% of the total number of directors, whichever is greater. Importantly, rule 14a-11 does not apply if the company’s governing documents prohibit shareholders from nominating director candidates.

Rule 14a-11 was drafted from the perspective of facilitating the effective exercise of state law rights to nominate and elect directors to company boards. For example, it does not pre-empt Delaware’s recent legislation which permits corporations to include in their bylaws provisions requiring the corporation to include directors nominated by shareholders in proxy materials, though Rule 14a-11 will require companies to allow shareholder nominees regardless of any action.

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147 Shareholder Nominations, 17 C.F.R. § 240.14a-11(a) (2010); see Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,782.
148 17 C.F.R. § 240.14a-11(b); see Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,782-83.
149 17 C.F.R. § 240.14a-11(d); see Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,785.
151 DEL. CODE ANN. tit. 8, §§ 112 & 113 (2010).
taken by companies, with the exception of an outright ban on nominations.\textsuperscript{152}

Proponents of shareholder empowerment have argued shareholders should make use of their latent power to hold boards of directors accountable, particularly in light of the 2008 financial crisis.\textsuperscript{153} However, many constituencies oppose such access, and the notions of corporate democracy and shareholder proxy access remain controversial.\textsuperscript{154} It is therefore important to evaluate the arguments against, as well as in favor of, increased shareholder proxy access to fully understand the dynamics of this potentially major change in corporate governance.

B. Arguments Against Shareholder Proxy Access

Some commentators, including many from the business management community, oppose allowing shareholders proxy access to nominate directors. Reasons for opposing access can be divided into the following categories: (1) access is unnecessary, (2) access does not serve, and may hurt, economic stability, (3) access hurts corporate performance, (4) access does not serve the goals of corporate democracy and fairness, plus there are (5) corporate responsibility concerns, (6) federalism concerns, and (7) workability concerns. Each argument is summarized below.

1. Proxy Access is Unnecessary

For at least two decades, commentators have argued that corporate democracy advocates are a movement in search of a cause.\textsuperscript{155} Some continue to argue that mismanagement is the exception and that, as a general rule, directors approach their duties with care.\textsuperscript{156} If shareholders are nevertheless unhappy with decisions made by the board of directors, they have an available remedy: sell their shares.\textsuperscript{157}

\textsuperscript{152} See Facilitating Shareholder Director Nominations, 17 Fed. Reg. at 56,678-80.
\textsuperscript{154} Regarding the SEC's 2007 shareholder proxy access proposal, see Cane & Silva, supra note 141, at 249 ("[S]ome commentators observed 'the regulatory approach taken in the Proposal [was] unnecessarily complex and in some aspects poorly aligned with shareholder interests.'" (quoting Comment Letter from John C. Wilcox, Senior Vice Pres., Head of Corp. Governance & Hye-Wo Choi, Vice Pres. and Assoc. Gen. Counsel, Corp. Governance, Teachers Ins. & Annuity Ass'n of Am., to Nancy M. Morris, Sec'y, SEC (Sept. 20, 2007), available at http://www.sec.gov/comments/s7-16-07/s71607-199.pdf) (citation omitted); see also infra Part III.B.
\textsuperscript{155} See Larry E. Ribstein, Comment, Edited Transcript of Proc. of the Bus. Roundtable—Emory U. L. & Econ. Center Conf. on Remedies Under the ALI Proposals: L. and Econ., 71 CORNELL. L. REV. 357, 361 (1986) (Professor Michael Bradley noted that "comments were made about the ravages in the market for corporate control and all of the abuses, but there has been no articulation of the problems at hand.").
\textsuperscript{156} See Craig Owen White, Comment, Corporate Governance: Directors vs. Shareholders?, 55 CASE W. RES. L. REV. 569, 574 (2005).
\textsuperscript{157} See id. at 576.
While Professor Bebchuk argues this imposes an injustice on shareholders who are forced to sell their shares at less than their maximum value,\(^ {158} \) Professor White argues that too many other factors affect share price to easily "draw a direct positive correlation between the composition of the board of directors and the market's valuation of a corporation at any given time."\(^ {159} \) The difficulty of determining whether mismanagement caused the devaluation of shares might suggest that the costs imposed on corporations and the SEC by a proxy access rule may outweigh any fairness considerations.\(^ {160} \)

Another common argument for maintaining the status quo is that technology solves the problem of inadequate shareholder oversight.\(^ {161} \) In addition, production and distribution cost differentials that place shareholders at a disadvantage may be better addressed by the SEC's recent E-Proxy rules, "which permit reliance on proxy materials posted on a website."\(^ {162} \) The real issue in such a situation might be what kinds of disclosure are required, rather than access to proxy materials.\(^ {163} \)

### 2. Economic Stability

One of the major rationales for providing shareholder proxy access is that it might remedy some of the problems that resulted in the recent financial crisis.\(^ {164} \) In response, opponents of shareholder proxy access argue the current system is better at maintaining economic stability.\(^ {165} \) Bratton and Wachter argue: (1) shareholders have a myopic perspective that focuses on stock price at the expense of long-term stability; (2) risk averse managers make safer decisions; and (3) directors have better access to information necessary to make effective decisions than do shareholders.\(^ {166} \) They also answer two arguments in favor of shareholder proxy access, arguing shareholders do not have superior incentives to maintain stability, and stock price efficiency does not


\(^ {159} \) White, supra note 156, at 576. But see infra Part III.C.1; cf. supra notes 30-33 and accompanying text (collapse of Lehman Brothers).

\(^ {160} \) See White, supra note 156, at 576.

\(^ {161} \) See, e.g., id. at 578-79 ("The monopoly of communicating with shareholders through the formal proxy mechanism once held by corporations has been left in tatters by the Internet, web pages, e-mail, group mail, and now 'blogs.'").


\(^ {163} \) See id. at 487-91.

\(^ {164} \) See infra Part III.C.3.


\(^ {166} \) See id.
solve the problem of inequitable information distribution.\textsuperscript{167} Empirical evidence indicates shareholders may bear some responsibility for worsening the financial crisis because shareholder pressure encouraged riskier strategies to raise stock prices, suggesting that shareholder empowerment may not create effective oversight for the good of the economy as a whole.\textsuperscript{168}

3. Corporate Performance

Some have argued shareholder proxy access may damage corporate performance for a variety of reasons. One of the primary objections, as noted above, is that shareholders' myopic focus on short-term increases in stock price may interfere with long-term planning and increase the probability of risky corporate decisions.\textsuperscript{169} The problem may be intensified in the context of institutional investors, who have greater incentives to focus on short-term results because they lack access to firm-specific information and are in a better position to evaluate a company's short-term value.\textsuperscript{170} Institutional investors may also use proxy access to wage destructive proxy battles and make it more difficult for corporations to find qualified directors.\textsuperscript{171} This may damage the operations of the majority of corporations, which do not face governance problems, to solve the problems faced by a minority of companies.\textsuperscript{172}

Additional arguments have been offered to show that proxy access and shareholder oversight will not improve corporate performance. First, even if corporate shareholders obtain proxy access, it is possible they may not use it.\textsuperscript{173} Second, encouraging election contests may discourage competent incumbent

\textsuperscript{167} See id. at 660.

\textsuperscript{168} See id. at 720-23 (concluding that "[s]hareholder power was a part of the problem and is not a part of the solution.").

\textsuperscript{169} See supra note 166 and accompanying text.


\textsuperscript{171} Lewis J. Sundquist III, Comment, \textit{Proposal to Allow Shareholder Nomination of Corporate Directors: Overreaction in Times of Corporate Scandal}, 30 WM. MITCHELL L. REV. 1471, 1494-95 (2004). See also Comments of Wachtell, Lipton, Rosen, & Katz (June 11, 2003), http://www.sec.gov/rules/other/s71003/wachtell061103.htm; Facilitating Shareholder Director Nominations, supra note 111, 74 Fed. Reg. at 29,026 (noting concerns that shareholder-nominated directors may act on behalf of a small number of shareholders and that such directors may disrupt the functioning of the board).

\textsuperscript{172} Sundquist III, supra note 171, at 1495.

\textsuperscript{173} See Stephen M. Bainbridge, Response, \textit{Director Primacy and Shareholder Disempowerment}, 119 HARV. L. REV. 1735, 1757 n.113 (2006); Jeffrey N. Gordon, \textit{Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice}, 76 CAL. L. REV. 1, 43 (1988) (arguing shareholders may be "rationally apathetic[.]") in that the "cost of informing oneself sufficiently to cast an intelligent vote on a management proposal frequently exceeds the expected payoff[.]").
directors from seeking re-nomination. 174 Third, outside directors reduce the homogeneity of boards, which could disrupt their cohesiveness and the decision-making process. 175 Fourth, shareholder proxy access risks contested elections, which may waste company resources or disrupt the function of the board of directors. 176 Fifth, shareholder power may increase the power of institutional investors, which over-rely on the advice of independent advisors, risking a one-size-fits-all approach to governance which may be dangerous because it overlooks the diverse needs of different companies. 177 Special-interest shareholders may also be more likely to take an activist role, which could destabilize a corporation. 178 Finally, shareholder proxy access may distract directors, forcing them to consider the public relations effects of every decision and potentially second-guess decisions they believe to be in the best interests of the corporation. 179

4. Fairness and Democracy

Part of the opposition to shareholder proxy access may stem from conflicting philosophies regarding the role of democracy in the proper functioning of a corporation. According to one traditional view, corporations are properly founded on a separation between ownership and control, which leads to more efficient outcomes. 180 Shareholders are properly viewed as owners of a corporation, while boards of directors are tasked with making most corporate decisions. 181 Corporations are not political entities, but economic entities with which shareholders entrust capital, which is then managed by professionals who attempt to maximize profits


176 Martin Lipton & William Savitt, The Many Myths of Lucian Bebchuk, 93 VA. L. Rev. 733, 743-48 (2007) (arguing this point, in addition to shareholder myopia, weakened board decision-making, and deterrence of qualified directors from serving on boards); Comment Letter on 2007 Proposals from Anne M. Mulcahy, supra note 175.

177 White, supra note 156, at 572-73.

178 Id. at 572 (speculating corporations could be held hostage by special interest shareholders).

179 Id. at 578.


derived from that capital. This view suggests that democratic government is an inapt metaphor for corporate governance.

Shareholder empowerment also raises questions regarding which shareholders will actually be empowered by proxy access. Access may empower certain special interest shareholders who might make decisions which are not in the best interest of the shareholders as a whole. Minority shareholders may use their access to hurt shareholders with divergent interests. Hedge funds and other activist shareholders are of special concern. It has been argued that if the new rule contains a large number of provisions, hedge funds and activist shareholders may be able to exploit loopholes in the new rule to influence control of the corporation.

5. Corporate Social Responsibility
In addition to harming the corporation, opponents to shareholder proxy access argue shareholder short-termism may have undesirable effects on non-shareholder stakeholders. According to this argument, boards mediate between the interests of different stakeholders. Shareholder empowerment may force directors to focus on short-term returns at the expense of other constituencies, interfering with the goals of corporate social responsibility.

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182 White, supra note 156, at 572.
183 Id.; Comments of Task Force on Shareholder Proposals, Section of Business Law of the American Bar Association (June 13, 2003), available at http://www.sec.gov/rules/other/s71003/aba061303.htm (arguing corporations are not political entities); Comments of American Society of Corporate Secretaries (June 13, 2003), available at http://www.sec.gov/rules/other/s71003/ascs061303.htm (arguing the different duties stemming from corporate and state elections show they are not analogous).
185 Iman Anabtawi & Lynn Stout, Fiduciary Duties for Activist Shareholders, 60 STAN. L. Rev. 1255, 1257-58, 1281-83, 1294-96 (2008) (arguing shareholder empowerment must be accompanied by new shareholder duties to prevent abuse); Sundquist III, supra note 171, at 1494 (noting access may give power to a few special-interest investors, hurting democracy); Comment Letter from Keith F. Higgins, Committee Chair, Committee on Federal Regulation of Securities of A.B.A., Sec. of Bus. L., to Nancy M. Morris, Secretary, U.S. Securities & Exchange Commission, on Shareholder Proposals in Release Nos. 34-56160 and 34-56161 (Oct. 2, 2007), available at http://www.sec.gov/comments/s7-17-07/s71707-126.pdf (arguing access hurts the rights of other shareholders who are also entitled to management time and focus).
186 Posting of Charles M. Nathan, supra note 174.
187 See Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 VA. L. Rev. 247, 304-05 (1999) (noting the impact, for example, on the firm’s employees).
6. Federalism

Another objection to an SEC rule facilitating shareholder proxy access is that if the SEC mandates increased access, it might intrude on areas of business regulation that have traditionally been left to state governments. Without the flexibility to allow states to limit shareholder proxy access, mandatory access could represent a substantial encroachment on state regulatory power.199 Shareholder rights have traditionally been regarded as lying within the realm of state regulation.190 A critical element of the federalism argument is that while the SEC has the power to regulate so as to ensure investors have access to basic information about securities they purchase, a mandatory proxy access rule may stray too far into the realm of substantive regulation, which might be beyond the scope of the SEC’s power and better addressed by state law.191 Some commentators argue not only is such substantive regulation of shareholder rights beyond the authority of the SEC, but states have more expertise in this area and are in a better position to protect shareholder rights.192

7. Workability

Critics of shareholder proxy access have cited possible workability problems with an SEC access rule.193 First, a mandatory access rule may be overbroad, failing to take into account the variety of board and capital structures that exist in American corporations.194 Second, proxy access may create the problem of “access-creep,” in which more directors are elected through the shareholder access process than the rule would intend, as a result of re-nominations.195 This could lead boards to deny re-nomination of directors who utilize the access process, interfering with board cohesion.196 Third, the access rule may encourage costly proxy contests, a problem that could be worsened by shareholders who might “use nominating groups with different compositions to end-run limitations based on prior low votes for access

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189 White, supra note 156, at 577 (2005).
190 Sundquist III, supra note 171, at 1497 (“A [federal] rule that allows shareholders direct access to a proxy statement for nomination purposes arguably could violate state law because state law grants nominations to the board.”) (footnote omitted).
191 Id. at 1497-98 (citing Bus. Roundtable v. S.E.C., 905 F.2d 406, 408 (D.C. Cir. 1990) (implying the SEC is limited in regulating matters beyond disclosure)).
194 Id.; Letter from Jeffrey W. Rubin, supra note 192, at 4-5 (arguing the SEC should defer prescriptive access in response to flexibility concerns).
195 Latham & Watkins, LLP, supra note 193, at 5-6.
196 Id.
candidates." Fourth, proxy access may allow parties to evade election disclosure requirements, and interfere with the informed decision-making process of shareholders, as the SEC argued in the past. Finally, it has also been suggested that a two-year holding period be implemented to ensure that nominations are available only to long-term shareholders.

8. Alternatives

Critics of shareholder proxy access have offered alternative mechanisms for addressing the democratic deficit in board elections without causing the problems they identify with prescriptive shareholder access. A common suggestion is that the SEC adopt a middle position—allowing shareholder access through bylaws, rather than mandating access. Proponents of a more flexible approach argue that it may be superior to a one-size-fits-all approach because it: (1) allows policies to be tailored to specific companies; (2) allows for experimentation between different companies, theoretically revealing the best approach to proxy access; and (3) allows for the evolution of state laws on the topic of bylaws and proxy access. Another alternative is the use of electronic forums, which supporters believe address problems with shareholder democracy while preventing myopia, waste, disruption, excessive empowerment of special interests, and deterrence of qualified directors from seeking election.

C. Arguments in Favor of Shareholder Proxy Access

A number of academics and proponents of shareholder activism argue that shareholder proxy access will have positive effects on corporations and the economy as a whole. Generally, it is argued the SEC should accomplish this by amending

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197 Id.
199 Latham & Watkins LLP, supra note 193, at 6.
201 McDonnell, supra note 200, at 260-61. See also id. at 261-62 (noting—but dismissing—problems with the optional approach, including the possibilities that the bylaws may not be binding under state law, that companies could avoid implementing a proposal by requiring the board to approve shareholder nominees, and that the rule would result in a confusing number of company-specific rules); Securities and Exchange Commission, Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors 26, 30 (July 15, 2003), available at http://www.sec.gov/news/studies/proxyrpt.htm (discussing advantages and disadvantages of a bylaw approach).
203 For general defenses of shareholder democracy, see Lucian Arye Bebchuk, The
SEC Rule 14a-8 to adopt a uniform rule allowing shareholders to nominate directors via proxy materials.\textsuperscript{204} Rationales for more meaningful shareholder access may be divided into (1) fairness and democracy, (2) corporate performance and accountability, and (3) economic stability. Each rationale is summarized below, followed by responses to major criticisms of shareholder proxy access proposals.

1. Fairness and Democracy

Proxy access campaigns take place in the larger context of movements to remedy the perceived democratic deficit of how American corporations nominate and elect their boards of directors.\textsuperscript{205} Critics of the status quo argue the democratic process of electing directors has become ineffective, insulating incumbent directors from being voted out by dissatisfied shareholders.\textsuperscript{206} The SEC has acknowledged that one of the goals of its proxy rules is to ensure that a proxy mirrors an actual shareholder meeting insofar as doing so is practical.\textsuperscript{207} Proxy access may allow for more effective corporate democracy by giving shareholders a reliable means to nominate directors, even if they do not actually exercise that power.\textsuperscript{208} This may provide for a more fair and equitable environment in which shareholders can become empowered and exercise control over the directors to which they delegate

\textsuperscript{204} Goforth, supra note 203, at 448-50.
\textsuperscript{207} Facilitating Shareholder Director Nominations, supra note 111, 74 Fed. Reg. at 29,025-26.
\textsuperscript{208} Goforth, supra note 203, at 434-37.
management authority.\textsuperscript{209} Proxy advocates disagree with those who argue that dissatisfied shareholders already have an available remedy—selling their stock—and argue that it is unjust to force shareholders to sell their stock at a reduced value because of mismanagement by the board of directors.\textsuperscript{210} Proxy access may also improve disclosure surrounding director nominees.\textsuperscript{211}

Shareholder proxy access advocates argue that current mechanisms are insufficient to give rise to true corporate democracy.\textsuperscript{212} They point to imperfections in the market for corporate control, including anti-takeover statutes and defensive maneuvers that have allowed boards to effectively shield their power from outside challenges.\textsuperscript{213} While technological solutions, such as shareholder forums and e-proxy, seem to pose a means of improving corporate democracy by reducing costs imposed on shareholders seeking to dislodge ineffective directors, that may not be enough: "the e-proxy rules may fail to generate significant cost savings, majority voting may prove illusory, and shareholder forums may evolve into mere chat rooms ignored by corporate managers."\textsuperscript{214} While it is possible such mechanisms may have an indirect effect on shareholder power, that effect will only be useful if those mechanisms provide a means by which directors effectively engage with shareholders.\textsuperscript{215} Proxy access may also be superior to an alternative offered by the American Law Institute—nomination of outside directors—because it allows shareholders to prod directors, including passive unaffiliated directors, into making more effective decisions.\textsuperscript{216}

2. Accountability and Corporate Performance

A second justification for shareholder proxy access is that it provides for better corporate performance and decision-making by assuring boards of directors are accountable to shareholders.\textsuperscript{217} The financial crisis and poor decisions made by

\textsuperscript{209} Fairfax, supra note 115, at 1267-68.
\textsuperscript{210} See Bebchuk, supra note 158, at 561.
\textsuperscript{211} Brown, Jr., supra note 140, at 1380-82.
\textsuperscript{212} Fairfax, supra note 115, at 1305-06 (arguing e-proxy, majority voting, electronic shareholder forums, and board declassification fail). See also Comment Letter from Michelle Edkins, Acting Chairman, ICGN S'holder Rights Comm., to Nancy M. Morris, Secretary, U.S. Sec. & Exch. Comm’n, on Shareholder Proposals in Release Nos. 34-56160 and 34-56161 (Oct. 2, 2007), available at http://www.sec.gov/comments/s7-16-07/s71607-462.pdf ("[Electronic shareholder forums are] an enhancement to rather than a replacement for more formal channels of communication between shareholders and companies, such as the general meeting and the proxy process.").
\textsuperscript{213} Goforth, supra note 203, at 447; Barnard, supra note 206, at 84-85.
\textsuperscript{214} Fairfax, supra note 115, at 1305.
\textsuperscript{215} Id. at 1305-06.
\textsuperscript{216} Goforth, supra note 203, at 438-40.
firms like Enron and Lehman Brothers illustrate the problems created by insufficient board accountability.218 There is evidence that management at those two companies made poor choices—including high risk accounting, conflicted transactions, unrecorded activities, excessive executive compensation, and a “leisurely approach to overseeing the risk decisions and standards”—primarily through excessive concentration of power in the hands of the CEO, who was able to hand-pick most board members.219 Shareholders are effectively prevented from ensuring accountability in the current system because of high agency costs.220 Shareholders, including institutional investors, have relevant expertise and, if not for current SEC rules, they may be able to provide real oversight to boards of directors.221 This may overcome the problems posed by directors’ self-interest and ineffective decision-making, particularly in the areas of takeovers and executive compensation.222

There remains the risk that shareholders will not exercise proxy access in a meaningful way, but proponents argue that the current model poses so many problems that we should attempt to reform it in the hopes that shareholders will hold directors accountable.223 Commentators identify a litany of possible positive effects of such accountability.224 There is also evidence suggesting a correlation between shareholder activism and firm value, in that firms have performed well when shareholders have been permitted to be more active in selecting management.225

218 Cane & Stacey, supra note 141, at 241-42.
220 Brown, Jr., supra note 140, at 1339-42.
221 Barnard, supra note 206, at 37-41.
222 Goforth, supra note 203, at 414-30.
223 Id. at 432-34.
224 See Comm. on Capital Mkts. Regulation, Interim Report 93 (Nov. 30, 2006), available at http://www.capmntskreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (arguing that shareholder empowerment will provide accountability, lower agency costs, raise share value, improve competitive equity, require more market discipline on the part of managers, and allow for less regulation and litigation); Barnard, supra note 206, at 90-92 (arguing that competition for directorial positions energizes board decision-making, stops incumbent entrenchment, allows institutions to apply their expertise to troubled companies, allows shareholders to take action to stop harm from mismanagement before it occurs, and increases share value); Peter Dodd & Jerold B. Warner, On Corporate Governance: A Study of Proxy Contests, 11 J. Fin. Econ. 401, 435 (1983) (arguing proxy contests have a positive effect on share prices).
225 See Fairfax, supra note 205, at 25 (noting international evidence from the United Kingdom, as well as possible limitations to the applicability of the study) (citing MARCO BECHT ET AL., RETURNS TO SHAREHOLDER ACTIVISM: EVIDENCE FROM A CLINICAL STUDY OF THE HERMES U.K. FOCUS FUND 6-7 (Eur. Corp. Governance Inst., Finance Working Paper No. 138, 2006),
3. Economic Stability

While the traditional rationales for shareholder proxy access have centered around the performance of specific corporations, the 2008 financial crisis gave rise to arguments that shareholder proxy access was necessary for broader economic stability. Some critics lay part of the blame for the crisis at the door of poor management and argue that shareholder empowerment may be able to address that problem. These arguments are similar to those for the accountability of particular firms, but also argue that such accountability will avoid the kinds of mismanagement that destabilized the economy and the financial system. Although short-term investing and the demands for increased stock value exerted by investors on boards of directors may be partially responsible for the crisis, shareholder proxy access can arguably ameliorate that effect by providing shareholders with a means of expressing their dissatisfaction with a company that is more consistent with implementing long-term strategies, as opposed to being provided the singular option of selling their shares, which arguably fosters a short-term perspective in order to minimize losses.

D. Answers to Objections to Shareholder Proxy Access

Critics often argue shareholders proxy access interferes with corporate effectiveness, in addition to risking other negative effects. Proxy access advocates have responses to these arguments. This Article now addresses objections to shareholder proxy access, specifically that it: (1) allows excessive empowerment of special interest shareholders; (2) wastes corporate resources; (3) contributes to dangerous short-term decision-making by boards of directors; and (4) impedes corporate social responsibility.


226 See Bratton & Wachter, supra note 165, at 656-57.
229 See Goforth, supra note 203, at 440-41; Roger Lowenstein, A Seat at the Table, N.Y. TIMES MAGAZINE, June 7, 2009, at 11.
230 See supra Part III.B.3.
1. Empowering Institutional Investors and Other Special Interests

The likelihood that shareholder activists will be institutional investors, such as unions and pension funds, may be a good thing for many stakeholders (such as employees and those affected by the environmental effects of a firm's conduct) who are insufficiently protected by the shareholder primacy norm of corporate decision-making.\textsuperscript{232} One tactic to ameliorate this concern, adopted by the SEC, is to amend the proxy rules in a way that limits the over-exertion of influence by institutional shareholders—for example, by limiting the number of directors shareholders can nominate.\textsuperscript{233} Regardless, institutional shareholders that nominate directors need to be careful that they insulate themselves from confidential information, avoid domineering behaviors, and recall that directors have fiduciary duties to all shareholders, not simply those who nominated them.\textsuperscript{234}

Critics have pointed to the possibility the ballot will be dominated by special interests, but that may not be much of a problem, since activists are more likely to succeed in using proxy access if their interests coincide.\textsuperscript{235} Finally, activism by hedge funds, another special interest group, is a recent phenomenon; its negative consequences remain speculative, and some studies suggest that it may have positive effects.\textsuperscript{236}

2. Corporate Waste

Some critics allege that shareholder proxy access wastes corporate resources.\textsuperscript{237} This argument can be broken into three parts: (i) shareholder nominations are wasteful because shareholders are apathetic: (ii) shareholder-nominated candidates will disrupt the efficient functioning of homogenous boards; and (iii) access increases the likelihood of contested board elections, which are not only costly but may distract the board of directors from making effective decisions.

\textsuperscript{232} Id. at 176 (noting, for example, that union pension funds are likely to advocate positions that favor their constituents, the firm's stakeholder employees, rather than those that favor shareholders in general).

\textsuperscript{233} See Ribstein, supra note 155 and accompanying text. See also Goforth, supra note 203, at 450-53. "The simplest approach would be to limit the total number of nominations that a corporation must include in the proxy materials." Id. at 452.

\textsuperscript{234} Barnard, supra note 206, at 88-89.

\textsuperscript{235} Id. at 176-77.

\textsuperscript{236} Id. at 178-79 (noting recent studies showing hedge fund activism achieving positive gains, particularly in corporate governance). See also Fairfax, supra note 205, at 28-29 (acknowledging the problems of hedge fund influence, but arguing that other institutional investors that are interested in corporate democracy may check them and citing evidence of that effect from Germany).

\textsuperscript{237} See supra Part III.B.3.
i. Shareholder Apathy

Some critics argue that shareholder proxy access wastes resources because shareholders are apathetic and unwilling to wield the power that the SEC might give them. First, this argument may be circular because it is a prediction of future shareholder behavior based on the past, in which substantial barriers have existed to shareholder participation. Proxy access may change this pattern by making it less likely that shareholder proposals will draw management opposition and fail. Current shareholder apathy is arguably a symptom of status quo barriers to access. There are also reasons shareholders may be more willing to exercise power and participate in the governance process if permitted to do so. While international evidence suggests shareholders may be reluctant to use their proxy access to challenge directors, access may influence managers in more subtle ways by strengthening the effect of “withhold-the-vote” campaigns and enhancing shareholder-director dialogue. Finally, international evidence has shown that shareholders are more willing to exercise their power during times of crisis, indicating that investors will overcome their passivity when it is most important that they do so.

ii. Board Cohesion

Another objection is that shareholder proxy access will allow new directors, who may have special interest agendas, to infiltrate boards, interfering with cohesion. However, there is some theoretical evidence suggesting shareholder-nominated directors may be more willing to question a board’s traditional assumptions, leading to improved decision-making. Even if there is some risk of disruption, the current system already places a value on outside directors, meaning

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239 Goforth, supra note 203, at 443.

240 Id. at 442-43.

241 Id. at 443.

242 Barnard, supra note 206, at 79-84 (noting factors, including the end of the junk bond market and the rise of institutional investors investing in equity, regulatory oversight of the voting behavior of institutional investors, and mechanisms for lowering the cost of information gathering and voting).

243 Fairfax, supra note 205, at 23.

244 Id. at 23-24.

245 See Haft, supra note 175, at 22-24 (citing empirical evidence that outside voices can cause board disagreement, causing ineffective decision-making).

246 Goforth, supra note 203, at 443-44.

there is little risk that shareholder-nominated directors would impose a greater lack of cohesion than already exists on many boards of directors. Finally, there is a substantial amount of literature regarding the problem of group-think, whereby a homogenous group of individuals becomes blinded to problems faced by their organizations because of a tendency to penalize disagreement and marginalize contrary views. Shareholder-nominated directors may alleviate this problem by injecting new perspectives and forms of expertise.

iii. Proxy Contests

While critics argue that the risk of election contests may deter qualified directors from risking rejection by being nominated in a contested election, the lucratice benefits of holding such positions will likely override that effect. Costly control contests may also be avoided by setting criteria for shareholder nominations. It is also possible that competition for board positions will only increase the quality of the decision-making of those who end up on the board.

3. Short-Term Decision Making

Critics of shareholder proxy access also argue that shareholder empowerment may hurt corporate performance because shareholder myopia and shareholders’ interests in short-term profits will force directors to make decisions that are not necessarily in a firm’s long-term interests. One response to this objection is that current directors already focus on short-term concerns, and there is little reason to believe that shareholder-nominated directors will worsen the problem. If anything, by being able to participate in management through proxy

248 Goforth, supra note 203, at 444-45.
249 See, e.g., I. JANIS, GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOS 9 (2d ed. 1982).
250 Barnard, supra note 206, at 78-79.
251 Id. at 75.
252 For example, the new SEC rule 14a-11 limits director nominations to shareholders (or groups of shareholders) who have owned at least 3% of voting shares for at least three years, and limit the total number of shareholder director nominees to one or no more than 25% of the board, whichever is greater. See supra notes 154-155 and accompanying text; see also Goforth, supra note 203, at 450-53 (suggesting that shareholders be allowed to nominate no more than one-fourth of directors at a meeting and that short-term investors be barred from nominating directors).
253 Barnard, supra note 206, at 76.
255 Goforth, supra note 203, at 446; see also Rahul Kochhar & Parthiban David, Institutional Investors and Firm Innovation: A Test of Competing Hypotheses, 17 STRATEGIC MGMT. J. 73, 81-82 (1996) (arguing that institutional investors are able to reward long-term company performance).
access, shareholders may have an incentive to focus on a corporation’s long-term well-being and directors will still have a fiduciary duty to act in the corporation’s best interests. Pressure in favor of short-termism may be an inevitable problem of corporate governance, and the best way to deal with it might be to satiate shareholders by giving them limited proxy access without allowing them to engage in more substantial interference with the governance process. Finally, even if shareholders suffer from short-termism, the ability to nominate directors may correct that tendency by providing a mechanism for dissident shareholders to express their dissatisfaction with management in a manner that is more consistent with a long-term approach than their current remedy—selling their shares.

4. Corporate Social Responsibility

Lastly, some scholars argue that shareholder empowerment interferes with the interests of non-shareholder stakeholders. There are a number of responses to this. First, shareholder proxy access may cause a shift in shareholder focus towards long-term concerns. Second, proxy access may empower institutional shareholders that represent the interests of constituents who have been ignored by boards of directors in the past, such as environmental stakeholders and employees. Shareholders consist of diverse groups and some of them may have interests that align with those of non-shareholder stakeholders. International experience has borne out this argument to some extent. In Germany and France, employee stakeholders use their power to elect board representatives, which may be roughly analogous to employee pension funds that hold stock in a corporation.

256 Goforth, supra note 203, at 446.
257 Brown, Jr., supra note 140, at 1380; see also Barnard, supra note 206, at 86-88 (arguing that having some shareholder-nominated directors will not pose any more risk of short-termism than pure incumbent boards and that staggered boards may solve the problem).
258 Goforth, supra note 203, at 440-41 (arguing proxy access solves the “Wall Street Effect” problem of high investor turnover and short-term investing by providing an alternate remedy to selling stock); Zingales, supra note 227, at 24-27 (arguing shareholder nominations will channel shareholder interests into long-term values); Lowenstein, supra note 229.
259 See supra Part III.B.5.
260 See supra Part III.D.3.
261 See McDonnell, supra note 231, at 176.
262 Anabtawi, supra note 184, at 579-80; Fairfax, supra note 205, at 31 (citing Larry E. Ribstein, Accountability and Responsibility in Corporate Governance, 81 NOTRE DAME L. REV. 1431, 1459 (2006); Matheson & Olson, supra note 188, at 1487).
263 Id. (discussing the United Kingdom, where institutional investors pressured managers to engage in socially responsible conduct).
264 Fairfax, supra note 205, at 31.
III. Shareholder Primacy and the Business Judgment Rule Together Require More Shareholder Democracy

The current financial crisis naturally causes one to question whether the United States corporate governance structure needs revising. The financial crisis has served as the impetus for regulatory and Congressional attempts to enhance shareholder proxy access. The shareholder primacy norm remains the “bedrock principle of U.S. corporate law.” Under the business judgment rule, unless shareholders can rebut the presumption that directors were acting in the best interests of the corporation, those shareholders have no legal recourse against those directors, no matter how stupid, egregious, or irrational board decisions may be. Shareholders not only lack recourse in the courts, they also lack recourse in the selection and retention of directors.

This leaves only four choices: (1) abandon the shareholder primacy norm—i.e., reverse centuries-old attitudes towards the role of corporations; (2) modify the business judgment rule—which recent court decisions indicate is not being contemplated; (3) let shareholders sell their shares—which is of little consequence if share values have dropped dramatically due to director misfeasance; or (4) grant shareholders greater power in determining the make-up of the board of directors, particularly through access to the proxy to nominate board candidates.

Shareholder democracy is fundamentally an issue of the role of shareholders within the corporation and of their power. But even this notion is subject to debate. For example, one commentator asserts that beginning in the 1930s, theorists, such as Berle and Means, and policymakers shifted the debate from the role of the corporation in society to the internal control hierarchy within the corporation between shareholders and management. This hierarchy helped assuage concerns over concentration of power within corporations because the “owners” did not

See, e.g., Facilitating Shareholder Director Nominations, supra note 111.
The nation and the markets have recently experienced, and remain in the midst of, one of the most serious economic crises of the past century. This crisis has led many to raise serious concerns about the accountability and responsiveness of some companies and boards of directors to the interests of shareholders, and has resulted in a loss of investor confidence. These concerns have included questions about whether boards are exercising appropriate oversight of management, whether boards are appropriately focused on shareholder interests, and whether boards need to be more accountable for their decisions regarding such issues as compensation structures and risk management.

Id., 74 Fed. Reg. at 29,025; see also section 971 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, supra notes 144-145 and accompanying text.

See supra note 38 and accompanying text.
See supra notes 112-115 and accompanying text.
Joo, supra note 205, at 1584.
control those corporations. This shift instigated the entire debate about the role of shareholders and what, exactly, they "own."

Are shareholders merely investors looking for a return on their investment, or are they entitled to participate in determining the direction of the corporation? If shareholders are the former only, then there is very little need for them to participate in the management of the corporation. They can minimize their financial risk by owning a diversified collection of stocks, in which case the "Wall Street Walk" is a practical solution for an underperforming investment.

If the shareholders own the corporation just as any others own private property—with all the attendant rights associated with private property ownership—then the wishes of the shareholders must be the paramount focus of the corporation. But Lipton and Rosenblum find two fundamental flaws in this argument. First, they argue that corporations play too important a role in the economy to be subject to the personal interests of shareholders. They assert the passage of general incorporation statutes reflects a policy choice that the role of shareholders is simply to aggregate capital, with the promise of limited liability in return. It should be left to management to best determine how to deploy that capital for the good of society. Second, Lipton and Rosenblum argue that ownership of corporate stock is not analogous to ownership of ordinary property, in that ownership of stock is merely "a financial investment granting no direct control over the properties, equipment, contract rights, organizational structure, and other elements that make up the corporation itself." They claim shareholders do not care about the corporation any more than the holder of a betting slip cares about the racehorse bet upon.

Although Bainbridge offers differing views as to the role of shareholders, his conclusions are similar. Bainbridge adopts Arrow’s delineation of decisions between consensus and authority. Shareholders are a diverse group and although unified

271 Id. at 1585.
273 See supra note 5; see also Sundquist III, supra note 171, at 1490-91 (using the "Wall Street Walk" as a distinguishing factor between shareholder democracy and governmental democracy in that participation in a corporation—i.e., owning shares—is voluntary).
275 Id. at 192-93.
276 Id. at 193.
277 Id. at 192-93.
278 Id.
279 Id. at 194 ("Just as the bettor does not really care about the fate of the racehorse as long as it provides him a financial payoff, so too the stockholder/investor does not really care about the fate of the corporation as long as the stock generates a profit.").
280 Bainbridge, supra note 173, at 1745 (citing KENNETH J. ARROW, THE LIMITS OF
by a desire for wealth maximization they will usually disagree about the best way to achieve it.\textsuperscript{281} In addition, shareholders lack incentives to gather the information necessary to participate actively in decision-making, resulting in rational apathy.\textsuperscript{282} As a result, corporate management is more effective at authoritative decision-making rather than at consensus building.\textsuperscript{283}

Regardless of the degree of power shareholders should theoretically have, they have entrusted their money to the board of directors. A theory of "love-it-or-leave-it" blind trust in corporate management ignores the principle that trust demands accountability. As discussed earlier,\textsuperscript{284} absent fraud or gross negligence, directors have no legal accountability. Even when the corporation is viewed as merely an investment vehicle, there are still arguments supporting some degree of shareholders' right to control the corporation's direction.\textsuperscript{285}

Corporate directors were initially considered trustees of the corporation and its shareholders.\textsuperscript{286} Although directors are no longer considered trustees,\textsuperscript{287} the trust concept was the foundation for the shareholder primacy norm.\textsuperscript{288} When these initial doctrines regarding the role of directors were first being established, directors were members of the shareholding body, selected by the other shareholders to protect their mutual interests, usually on a purely voluntary basis.\textsuperscript{289} In tracing the history of corporate boards, Gevurtz concludes the use of boards arose out of problems with direct governance by groups with large numbers of members.\textsuperscript{290}

It was within this framework that the first doctrines of director liability

\textsuperscript{281} Id.
\textsuperscript{282} Id. (explaining that the opportunity cost entailed in making informed decisions is significant while the expected benefits of becoming informed are quite low, since most shareholders' holdings are too small to have significant effects on a vote's outcome).
\textsuperscript{283} Id. at 1746 n.56 (describing the benefits of using centralized decision making versus soliciting input from thousands of decision-makers).
\textsuperscript{284} See supra Part II.B.
\textsuperscript{285} See, e.g., Comments of Task Force on Shareholder Proposals, Section of Business Law of the American Bar Association, supra note 183 (asserting "[t]he modern publicly held corporation is primarily an economic entity whose function is to create wealth for its owners (institutional or individual)"") yet stating "[t]he distribution among shareholders under corporate law of voting power and the right to receive dividends reflect ... " that function); Lipton & Rosenblum, supra note 275, at 194 (stating "stockholders deserve a prominent voice in corporate governance") (footnote omitted). Lipton & Rosenblum argue that corporate governance systems must consider stockholders, the corporation, other stakeholders, and the health of the economy and society as a whole. Id. at 195.
\textsuperscript{286} See supra note 21 and accompanying text.
\textsuperscript{287} Schoon v. Smith, 953 A.2d 196, 206 (Del. 2008) (citing Guth v. Loft, 5 A.2d 503, 510 (Del. 1939)).
\textsuperscript{288} See supra notes 23-26 and accompanying text.
\textsuperscript{289} See supra note 46.
\textsuperscript{290} Franklin A. Gevurtz, The Historical and Political Origins of the Corporate Board of Directors, 33 Hofstra L. Rev. 89, 167 (2004).
arose. The courts resisted holding directors to too high a standard, for fear the potential liability would dissuade qualified shareholders from serving as directors.\(^{291}\) As such, courts were reluctant to hold directors liable for honest mistakes, regardless of how "absurd" or "ridiculous."\(^{292}\) Over the past 130 years, this reluctance has evolved into the business judgment rule that holds directors legally blameless unless they consciously ignore their duties or engage in self-dealing.\(^{293}\) The business judgment rule also retained an historic assumption that has proved false in modern times—dissatisfied shareholders can vote out incompetent directors.\(^{294}\)

In the meantime, a recognized transfer of control in large, publicly traded corporations from shareholders to management has occurred. While directors are still expected to maximize shareholder wealth, shareholders have no direct practical control over management. This control gap could have been alleviated by restrictions on the business judgment rule—holding directors to a higher standard of care to protect shareholder interests—but instead the business judgment rule did not evolve in the same manner as corporate control. It continued from precedents established long before the separation of management and control.

As a result, the most practical option remaining to protect shareholder interests is to give shareholders additional management powers—specifically through access to the proxy to nominate directors. This will not result in shareholders becoming substantively involved in the management of the corporation. It is not a proposal to return to the early days of corporations when the shareholders were also the directors, looking after their own interests. But the law is stuck in those early days of corporate history. Shareholder proxy access at least provides shareholders some degree of protection when the law otherwise will not.

**IV. Conclusion**

Despite the fact the shareholder primacy norm places shareholder value first and foremost, a number of constituencies have linked the current financial crisis with current corporate governance practices—to the financial detriment of shareholders and society as a whole. When shareholder primacy backfires, shareholders are left with substantial losses and minimal legal recourse due to the business judgment rule. The most viable possible revision to corporate governance in the United States is to allow shareholders access to proxies to nominate alternative directors. There is a strong argument that if there is a real chance directors can be replaced, they will exercise much greater care in protecting shareholder interests. While it is doubtful

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\(^{291}\) See *supra* note 46.

\(^{292}\) See *supra* note 47 and accompanying text.

\(^{293}\) See *supra* Part II.B.

\(^{294}\) See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985).
shareholder proxy access revisions alone will prevent the next financial crisis, they are at least a step forward in corporate democracy—providing shareholders with a meaningful voice in controlling their financial future.