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INTRODUCTION

On October 14, 2003, the Securities and Exchange Commission (SEC) issued proposed proxy rules that would permit shareholders to use a company's proxy statement to run a director election contest.[1] The advocates of these proposed rules make familiar arguments. They assert that there is a fundamental problem with American corporate governance, namely that directors and managers are insufficiently responsive to the wishes of shareholders. With this as their premise, they conclude that enhancing the power of shareholders to nominate and elect dissident directors to a company's board will help solve what they characterize as the problem of unresponsive incumbents.

Allowing shareholders to run an election contest through the company's proxy statement, however, would be a serious mistake. Increasing the ease and frequency of election contests would have a negative impact on public companies and their boards, with no clear benefit. A number of issues are immediately apparent: the risk of an influx of special interest directors; the disruption and diversion of resources that would accompany annual election contests; the risk of balkanized and dysfunctional boards; the risk of deterring the most skilled men and women from serving on public company boards. In addition, there is serious doubt as to whether institutional shareholders, public pension funds, and labor unions—the parties most likely to qualify for the right to include director nominees in a company's proxy statement under most proposals—are well-suited to the role of nominating directors. Each has duties to its own constituencies; each has its own agenda; but none has legal duties or obligations to the public company or other shareholders. Particularly in the context of the sweeping corporate governance reforms that have been adopted in the last year, and as we wait to assess the ultimate impact of these reforms, there is simply no compelling case for a new set of regulations designed to facilitate election contests.

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1. Proposed Rule: Security Holder Director Nominations, Exchange Act Release No. 34-48626 (October 14, 2003) available at http://www.sec.gov/rules/proposed/34-48626.htm [hereinafter Proposed Rule: Director Nominations]

The arguments advanced in support of the proposed election contest rules contain a number of unspoken and flawed assumptions. They rest primarily on a model of the shareholder as "owner" of the corporation, in the manner that an individual might own a car or a building. This model posits that directors and managers should simply be conduits to implement the will of the shareholders, just as a building manager is hired to serve the will of the building owner. To the extent that directors or managers of public companies do not implement the will of the shareholders, the argument continues, the corporate governance system is broken and needs to be fixed. The solution, therefore, is to facilitate the nomination of new directors by the shareholders — directors who presumably will do the shareholders' bidding.

The model of the corporation as a piece of personal or real property, however, is far too simplistic. The complex set of legal and contractual relationships that define the modern public corporation goes far beyond the model of a single owner of a single piece of property Although shareholders may be the residual risk takers in a public company, many other groups, including lenders, suppliers, employees, and communities, also make significant investments in the company Moreover, "the shareholders" are not a single monolithic body Far from the single owner of a building, the shareholders are a diverse and ever-shifting group of people and institutions, with differing interests and, in the case of institutional investors, differing obligations to their own diverse constituencies. In addition, unlike a single piece of property, the modern public corporation is the growth engine of our economy, giving the general public its own interest in the operation, governance and success of public companies.

The public company scandals embodied in Enron, WorldCom and the like have brought about a new focus on corporate governance reform. The reforms contained in the Sarbanes-Oxley Act and the recently adopted New York Stock Exchange and Nasdaq listing rules represent the most far-reaching set of new corporate regulation since the Securities Act of 1933 and the Securities Exchange Act of 1934.[2] Companies are now working to comply with both the letter and the spirit of these new regulations. Some have expressed concern about the cure being worse than the disease, suggesting that this new body of regulation may make directors and managers too risk averse. There is no doubt, however, that our corporate governance system relies on diligent and responsible oversight of

2 The Public Company Accounting Reform and Investor Protection Act of 2002 is commonly referred to as the 'Sarbanes-Oxley Act of 2002' Pub L No 107–204, 116 Stat 745 (2002) [hereinafter Sarbanes-Oxley Act] (codified at 15 U S C S § 7213 (2003)) On November 4, 2003, the SEC approved final corporate governance rules of the NYSE to be codified in Section 303A of the NYSE's Listed Company Manual See New York Stock Exchange, Final NYSE Corporate Governance Rules (November 4, 2003). available at http //www.nyse com/pdfs/finalcorpgovrules pdf [hereinafter NYSE Final Rules], Self-Regulatory Organizations, New York Stock Exchange, Inc and National Association of Securities Dealers, Inc , Exchange Act Release No 34-48745 (November 4, 2003) [hereinafter NYSE & Nasdaq Final Rule Approval] Also on November 4, 2003, the SEC approved final listing standards for Nasdaq regarding independence of boards and board committees See NYSE & Nasdaq Final Rules Approval, *supra*

public companies by experienced and talented directors. The new reforms, as well as the renewed scrutiny of corporate decision-making evidenced by recent Delaware case law, may have a positive effect in creating an even greater sensitivity to director responsibility and oversight.

Rather than now adding a new set of regulations that would fundamentally alter the existing corporate governance system, the best approach is to allow the reforms that have already been adopted to have their effect and to continue to improve the corporate governance system already in place. The existing system has developed over many decades, mostly at the state level, through an ongoing process of experimentation and experience. Recognizing the common interest in our public companies, each state imposes a comprehensive set of legal duties on directors and managers that are designed to ensure that they carry out their roles properly. The corporate scandals of the last two years clearly reflect a breakdown in the proper operation of those roles in specific cases. It is still open to debate as to whether the problem is isolated or more widespread. But there is nothing to suggest that the core problem is insufficient responsiveness to shareholder wishes. Indeed, one could argue that part of the problem is an over-responsiveness to the short-term outlook of those money managers and other shareholders for whom quarter to quarter performance is paramount.

Under the existing corporate governance system, shareholders already have a number of avenues to make their views known. These include: making public statements (a method that has proved very effective when voiced by respected professional investors); speaking privately with the company's management or with other shareholders; proposing a shareholder's resolution under Rule 14a-8; voting against management proposals; withholding authority from director candidates; and bringing pressure to bear on the company to engage in "value-enhancing" transactions. In addition, shareholders may propose potential director candidates to a company's nominating committee, which has a duty to consider bona *fide* candidates and to nominate directors they believe will best serve the interests of the company and all its shareholders.[3] Finally, shareholders have the right to nominate their own director candidates and wage an election contest—through their own proxy materials—to replace one or more of the incumbent directors. Typically an election contest is a last resort, as it should be in light of the extraordinary disruption that an election contest brings to bear on the entire organization. At the same time, the threat of an election contest that already exists, combined with the myriad of legal duties that apply to the directors and management of a public company, can serve to ensure that directors perform their oversight role well.

3. The SEC recently proposed additional rules to enhance pubiic companies' disclosure with respect to the nominating committee, how it operates, how it considers candidates and how shareholders may propose candidates to the committee. Disclosure Regarding Nominating Committee Functions and Communications between Security Holders and Board of Directors, Exchange Release No. 34-48301, (2002–2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,954, at 88,044 (Aug. 11,2003) [hereinafter Release No. 34-483011

Shareholder wishes are an important input in our corporate governance system, but they are not the only input. The legal duties and obligations that have developed over many years, and the recent reforms embodied in the Sarbanes-Oxley Act and recently adopted stock exchange rules, recognize the complexity of the modern public corporation. They seek to enhance the independence and oversight role of outside directors, balancing the various legitimate corporate interests and constituencies. The proposed election contest rules, in contrast, do not seek a balance. Rather, based on a flawed model of corporate ownership, they seek to give large shareholders a disproportionate ability to control corporate decision-making. For this reason, the proposed rules are fundamentally misguided. Having just witnessed, and participated in, the most extensive set of corporate regulatory activity in seventy years, the SEC should now take the time to assess the impact of these new regulations. As it has in the past, the SEC should decide not to adopt its proposed election contest rules, a set of rules that is almost certain to do more harm than good.

SHARE OWNERSHIP AND CORPORATE GOVERNANCE

As we observed over a decade ago, "[c]orporate governance is a means, not an end."[4] At that time we were responding to those who sought to encourage hostile takeover activity as a means of disciplining corporate managers and making them conform their actions to shareholder wishes. Today, we are responding to those who would encourage director election contests to serve the same goal. Many who once extolled the virtues of hostile takeovers as a means of disciplining managers now recognize the very real costs that the hostile takeover activity of the 1980s imposed on our economy[5] The advocates of facilitating election contests today base their arguments on the same premise—that the goal of corporate governance is to conform managerial action to shareholder wishes—without examining why and whether this is necessarily a good or healthy result. Instead, they rely on the notion that, because shareholders "own" the corporation, they have the intrinsic right to control it.[6]

4. Martin Lipton & Steven A. Rosenblum, A *New* System of Corporate Governance: *The Quinquennial* Election of Directors, *58* U. CHI. L. REV. 187, 187 (1991).

5. See, *e.g.*, Allen D. Boyer, Activist Shareholders, Corporate Directors, and *Institutional* Investment: Some Lessons From *the* Robber Barons, 50 WASH. & LEE L. REV. 977, 987–88, 1011, 1037 (1993) (stating that the "standard explanation of corporate takeovers, offered countless times during the 1980s, is the inefficiency of the target firm's management," but indicating that with benefit of hindsight, it is now recognized that "[t]akeovers and buyouts disrupted the institutions by which American economic production was organized" and that "[t]he producing economy was badly dislocated").

6. Lucian Bebchuk's article in this issue of *The Business Lawyer,* in support of election contest proposals, disclaims "shareholder voice" as an end in itself. However, the concept of the shareholder as "owner" or "principal" and managers and directors as "agents" who should conform their actions to what the shareholders want them to do, runs throughout his analysis. For example, Bebchuk frames the "critical question" as whether a company's nominating committee "can be relied upon to nominate outside candidates whenever doing so would enjoy widespread support among shareholders." Lucian Ayre Bebchuk, *The* Case *for* Shareholder Access to the Ballot, 59 BUS. LAW 43, 49 (2003). Similarly, he argues that shareholders should be given a better chance to nominate their own candidates to compete with those nominated by the incumbent directors "because the interests of an agent and principal do not always fully overlap." Id. at 57.

We have suggested a different goal for corporate governance, namely "the creation of a healthy economy through the development of business operations that operate for the long term and compete successfully in the world economy'" This goal relies not on intrinsic rights, but rather on social and economic utility, as the appropriate guideline for structuring and assessing a corporate governance system. Of course, shareholders should, and do, have a central role in the corporate governance systems that have developed over time in the United States and elsewhere. The goal, however, should be for shareholders and managers to work cooperatively towards the corporation's business success, not for shareholders to dictate managerial conduct on the basis of intrinsic rights.

THE NATURE OF SHARE OWNERSHIP

Comparing the shareholders' ownership of a public corporation to an individual's ownership of a piece of property is an often used but seriously flawed analogy This analogy is now at the center of the arguments in favor of giving shareholders the ability to run an election contest through the company's proxy statement. The comment letters submitted in response to the SEC's previous concept release, and the shareholder activists' response to the SEC staff's recommendation that the SEC propose director nomination rules of the kind now proposed, provide some examples:

- "[W]ealth is maximized when owners control—maintain and care for—their own property. Car owners maintain their cars better than car-renters, whether or not they are car experts."[8]
- "The SEC is tackling . . . the most important issue in American capitalism—the empowerment of ownership to hold fiduciaries to account for their stewardship of owner's interests and assets. . . . Meaningful access to the company's proxy ought to be a fundamental right of ownership."[9]
- "[S]hareholders, even though they own the company and it is their money that is at stake, are virtually powerless to do anything about company executives who use corporate assets for their own personal gain or directors who sit by passively and let it happen."[10]
- "If [the SEC] can give shareholders more say in the companies they own, more power to them."!'

7. Lipton & Rosenblum, supra note 4, at 189.

8. Letter from Sarah A.B. Teslik, Executive Director, Council of Institutional Investors, to Jonathan G. Katz, Secretary, SEC 1 (May 10, 2003), available at http://www.sec.gov/rules/other/s71003/cii051003.htm.

9. Letter from Richard A. Bennett, Governance Consultant, Lens Governance Advisors, P.A., to Jonathan G. Katz, Secretary, SEC 1 (June 11, 2003), available at http://www.sec.gov/rules/other/s71003/lensgapa061103.htm.

10. Letter from Ed and Peg O'Hara, to Members and Staff, SEC (June 13, 2003), available at http://www.sec.gov/rules/other/s71003/edpegohara061303.txt.

11. Judith Burns, UPDATE: Shareholder Advocates Applaud Proxy-Access Plan, Dow Jones News Service, July 16, 2003 (quoting Barbara Roper, Director of Investor Protection at the Consumer Federation of America).

Similarly, recent academic literature advocating greater shareholder empowerment also falls back on the ownership analogy For example, the analogy of the shareholders' ownership of a public corporation to an individual's ownership of "a building in Seattle" runs throughout a recent article by Lucian Arye Bebchuk entitled The Case *for* Empowering *Shareholders*.[12]

Private property is indeed at the center of a capitalist system. As a general matter, that system gives the owner of a piece of property the right to do with it as he or she wishes, subject to constraints designed to prevent or limit the use of the property in a manner that harms others. As we have explained in the past, however, the ownership of a share of stock in a public company is simply not analogous to the ownership of a car or a building in Seattle.[13]

A share of stock is a financial instrument, more akin to a bond than to car or a building. A share of stock does not confer ownership of the underlying assets owned by the corporation. Instead, it provides the holder with the right to share in the financial returns produced by the corporation's business. Some corporate scholars seek to contrast the rights of shareholders with those of debt holders and other corporate stakeholders by observing that debt holders' and other stakeholders' rights are defined by contracts. They argue that, for this reason, debt holders and other stakeholders are intrinsically entitled to no more rights than their contracts confer.[14] The flaw in this distinction is that the rights of shareholders are also defined by contracts, just different contracts. Shareholders' rights are defined by the corporation's charter and bylaws and by the corporate statutory law of the corporation's jurisdiction of incorporation.

Shareholders have no more claim to intrinsic ownership and control of the corporation's assets than do other stakeholders. Their claim is to the particular financial interest in the corporation that their contract rights confer on them.[15] Of course, it is in the interest of the corporation, and our economy as a whole,

12. Lucian Arye Bebchuk, The Case for Empowering Shareholders 15 (March 1, 2003) (Paper 86, Berkeley Olin Program Working Paper Series), at http:Nrepositories.cdlib.org/blewp/art86.

13. See Lipton & Rosenblum, supra note 4, at 191–95.

14. See Morey W. McDaniel, Bondholders and Corporate Governance, 41 Bus. LAW. 413, 413 (1986) (recognizing the established tenet of corporation theory that, "[sltockholders are owners; bondholders are creditors. Corporate law is for stockholders; contract law is for bondholders. Directors protect stockholders; the indenture protects bondholders"). McDaniel further argues that bondholders have as much interest as equity holders, albeit of different character, and thus should have as much protection as that afforded shareholders. Id.

15. See id. at 416 ("Stockholders, it is often said, are the owners of the corporation. But are they? In economic terms, stockholders and bondholders are all securityholders with differing claims on the assets and cash flow of an enterprise.") (citing Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, Corporate Director's Guidebook, 33 Bus. LAW. 1591, 1601 (1978)); see also Adolf A. Berle, Note, For Whom Corporate Managers are *Trustees*, Harv. L. Rev. 1365, 1367–70 (1931–1932) (making a distinction between ownership of "active" property, such as a farm or business, versus ownership of "passive" property and classifying corporate ownership via both equity and debt instruments in the latter, passive category because such ownership includes "a set of economic expectations evidenced by a stock certificate or a bond, each representing an infinitesimal claim on massed industrial wealth and funneled income-stream'' and because the owner of such "passive property is helpless to do anything with it or about it, except to sell for what the security markets will let [the owner] have").

to facilitate the ability to raise risk-taking capital. This leads the corporation, and state corporate law, to confer different rights on shareholders, who are the residual risk takers, than are conferred on debt holders and other stakeholders. The rights we choose to confer on shareholders, however, cannot be justified on the basis of their intrinsic right as the "owners" to control the corporation. Instead, we must examine whether the rights conferred on shareholders contribute to the economic success of the corporate enterprise, a goal in which all the corporation's stakeholders, and society generally, have an interest.

The owner of a share of stock stands in a very different relationship to the large public corporation and its business and assets than does the owner of a building or a small private company The owner of the building or private company is an individual (or small group) in a position to have full knowledge of, and to balance, all the considerations that go into decision-making about the proper use and operation of the property or business. The owner of a building or a small private business can fully appreciate the need to consider the interests of other stakeholders as part of the goal of making the operation of the building or small business a long-term success. The individual generally views the property or business as a complete entity, only exiting on the sale of the property or business as a whole. He or she has a direct interest in developing the property or business for the long-term, nurturing it, preserving its strength and ensuring its future. And, as sole owner of a building or a business, the individual is also subject to the set of legal constraints that statutory and judicial legal structures choose to impose to protect legitimate third-party interests.

In contrast, the shareholder of the large public corporation is one of a far-flung, diverse, and ever-changing group. Shareholders may enter and exit their ownership of shares in any given company as and when they choose.[16] Although they hold their shares, their interest is in a financial return, regardless of how that is achieved or what the long-term impact may be on the corporation and its other shareholders and stakeholders. In their capacity as shareholders, the legal system allows them to act purely in their self-interest. They are not fiduciaries and they do not owe legal duties to the corporation, other shareholders, or the corporation's other constituencies. This freedom of action is generally viewed as a central element in the structure of public corporation shareholding, one that serves our economy and the capital raising function of public corporations well.

Some advocates of permitting shareholders to run election contests through the company's proxy statement seem to suggest that this right is appropriate for, or could be reserved for, "long-term" shareholders, however that term may be defined. Long-term shareholding is also one of the criteria suggested by the SEC's

16. This ability freely to exit share ownership in the corporation is commonly referred to as "the so-called 'Wall Street Walk" or the "Wall Street Rule." See, *e.g.*, William B. Chandler III, On the Instructiveness of Insiders, Independents, and Institutional Investors, 67 U. CIN. L. REV. 1083, 1090 (1999). In his article in this issue of The Business Lawyer, Robert C. Pozen refers to the "Wall Street Rule" as "alive and well. In most cases when institutional investors are dissatisfied with the performance of a company's directors or executives, the investors simply sell the stock." Robert C. Pozen, Institutional Perspective *on* Shareholder Nominations of Corporate *Directors*, 59 BUS. LAW. 95 (2003).

proposed rules.[17] This implicitly recognizes that the transient nature of shareholding in a public corporation may distinguish the nature of share ownership in a public corporation from the ownership of a building or a private company The length of shareholding, however, is only one of many distinctions. If we are to try to define criteria to govern when a shareholder is more akin to an individual owner, and use that to create parameters for the 'right to nominate a director in the company's proxy, we would have to look at far more than the duration of share ownership. We would have to consider the other interests and agenda the shareholder may bring to the ownership of his or her shares. We would have to consider imposing new legal responsibilities and fiduciary duties to apply to shareholders that would use company resources to nominate their own director candidates. We would have to consider requiring shareholders that successfully nominate and elect a director to maintain a minimum level of share ownership thereafter (which is a very typical requirement attached to the right to nominate a director in contractual arrangements with large shareholders). All of these would potentially change the nature of the ownership of shares of a public corporation in fundamental and unhealthy ways, in addition to creating differing rights among shareholders of the same class. And even then, we would still not be able to replicate fully the aspects of ownership of a building that cause our system to grant the owner the right to control the management and operation of the building.

THE "AGENCY PROBLEM"

A corollary of the shareholder as owner analogy is the principal-agent analogy Much of the academic literature on corporate governance uses a model of the shareholder as principal and the manager as agent, applying an agency analysis to issues of corporate governance.[18] One of the central concerns of agency theory is the conflict between the interests of the agent and the interests of the principal. The literature on agency posits that, left to their own devices, agents will act in their own interests to the detriment of the principals' interests.[19] Thus, the "agency

17. See Proposed Rule: Director Nominations, supra note 1; see also Division of Corporate Finance, SEC *Staff* Report: Review of the Proxy Process Regarding Nomination and Election of Directors (July 15, 2003), at Appendix A, available at http://www.sec.gov/news/studies/proxyrpt.htm [hereinafter Staff Report: Review of the Proxy Process] (noting that commentators who were in favor of allowing shareholders to use the company proxy for director nominations, "generally supported a requirement that nominating shareholders hold their shares for a specified period of time").

18. See, *e.g.*, Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 AM. ECON. REV. 323 (May 1986); Aleta G. Estreicher, Beyond Agency Costs: Managing the Corporation for the Long Term, 45 RUTGERS L. REV. 513, 514–15 (1993) ("To many academic observers of the American corporation . . . agency costs (the principal's costs of monitoring and attempting to control the agents) have preoccupied the literature ever since the publication of Berle and Means' classic, *The* Modern Corporation and Pnvate Property") (citation omitted).

19. See, *e.g.*, Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 COLUM. L. REV. 795, 795 (1993) ("A key organizational feature of large United States corporations is the separation of ownership from control. This separation creates an agency problem, that managers may run the firm in their own, rather than the shareholders' interest, choosing the quiet life over the maximization of share value.").

problem" is how to ensure that agents will act as their principals want them to act. The academic literature on corporate governance, asserting that "[clorporate managers are the agents of shareholders,"[20] then uses agency theory to argue that the central issue of corporate governance is how to discipline corporate managers so that they will stop preferring their own interests to their principals' interests.[21] We have previously referred to this as "the managerial discipline model."[22]

Just as the analogy of the shareholder as property owner is flawed, so too is the principal-agent analogy The factors that distinguish the owner of a share of stock from the owner of a piece of property also distinguish the shareholder from the principal in the standard principal-agent relationship. In the principal-agent model, the principal is typically a sole owner, with direct knowledge of and interest in a property. who selects and monitors an agent to manage the property As we describe above, the shareholder in the public corporation is part of a wide and ever-changing body, whose ownership interest is a financial sharing interest defined by a set of contracts and legal principles. At any given time, it is likely that the managers will have been involved with the corporation far longer than the vast majority of the shareholders and will almost certainly have a much better and deeper understanding of the corporation's business operations. The shareholders do not select or determine the employment of the public corporation's manager as the principal/owner of a property employs an agent to manage the property Instead, shareholders buy and sell shared financial interests in an ongoing business enterprise.

In addition, as we note above, the shareholders constitute only one of the constituencies that make investments in and contribute to the success of the public corporation. It is for this reason that the legal principles governing public corporations have developed to impose on directors and managers a duty to act in the best interests of the *corporation*. Under normal circumstances: the best interests of the corporation will coincide, in the long run, with the interests of the shareholders, and the law recognizes that fiduciary duties are owed by directors and managers to shareholders as well. This does not mean, however, that every decision that directors or managers make in their good faith belief as to'the best interests of the corporation will necessarily be the same as the decision a majority of the shareholders would make on the same question were it put to a vote. The legal principles governing public corporations wisely permit directors and managers to make decisions that may be different from the decisions that a majority of the shareholders would make on any given matter at any given time.[23]

20. Jensen, supra note 18, at 323.

21. See, *e.g.*, Romano, supra note 19, at 795 ("The principal solution [to the agency problem] has been to call for more active monitoring of management by institutional investors.")(citing Bernard S. Black, Shareholder Passivity Reexamined, 89 MICH. L. REV. 520, 575–91 (1990)).

22. Lipton & Rosenblum, supra note 4, at 190–202.

23. See Proposed Rule: Director Nominations, supra note 1, at 7. The SEC's proposed rules would condition the ability to run an election contest through the company's proxy statement on one of two triggering events—a shareholder vote opting in to the access process or the withholding of proxy authority with respect to one or more directors by at least thirty-five percent of the vote. The SEC's release also seeks comment on a third potential triggering event, specifically the failure of the board

Moreover, under some circumstances, the interests of non-shareholder constituencies may come to the fore, such as the fiduciary duties to creditors that are imposed when the solvency of the corporation is at issue. All these principles, which have evolved over time and with extensive consideration, recognize that the relationship of directors and managers to shareholders in a public corporation is far more complex than the simple principal-agent relationship.

The principal-agent analogy also vastly underestimates the complexity of the motivations that act on the directors and managers of a public corporation. As noted above, the central tenet of agency theory is that, left to their own devices, agents will act in their own self-interest to the detriment of their principals. Thus, those who apply agency theory to corporate governance spend their energy looking for ways to discipline presumptively wayward directors and managers. Most directors and managers of public corporations, however, define themselves and measure their success in terms of the success of the corporations they direct and manage. Certainly one can point to instances of unwarranted compensation packages and claim them as proof of the "agency problem" in public corporations.[24] It could also be noted, however, that many of the huge compensation packages that ultimately became the target of criticism were in fact the product of the academic and shareholder campaign to "align" the,interests of shareholders and managers by giving managers large amounts of equity-based compensation. In any event, although directors and managers may be motivated by financial gain, they are equally motivated by reputation and satisfaction in the success of the corporations they run. Regardless of the compensation package, no director or manager wants to see the corporation he or she runs fail to succeed and thrive. Managers do not need to be "disciplined"; they need to be helped to run the company successfully.

THE LIMITS OF SHAREHOLDER MONITORING

Having demonstrated that the ownership analogy and the principal-agent analogy are flawed and insufficient bases for granting control power to shareholders as a matter of intrinsic right, we must next consider whether it would nevertheless be advisable to grant more control to shareholders (or some subset of shareholders) in public corporations as a matter of economic or public policy Academic

to implement a shareholder proposal that has received a majority vote. *Id.* The underlying suggestion of this third trigger is that boards should be required to take any action that receives the approval of a majority shareholder vote at any given time, and that the failure to do so constitutes a "breakdown" in the proxy process. *Id.* Not only is this notion a radical departure from existing law, but the pernicious effects were it adopted could be devastating to the corporation and all its constituencies. Even if the third trigger is not adopted, the triggering event mechanisms may still have the same effect indirectly, given the propensity of shareholder activists to organize withhold authority campaigns where a board fails to implement a shareholder proposal that has received a majority vote,

24. See Lucian Arye Bebchuk & Jesse M. Fried, *Executive* Compensation as an Agency *Problem,* 17 J. ECON. PERSP. 71, 89 (forthcoming 2003), available at http://www.law.harvard.edu/faculty/bebchuk/pdfs/2002.Bebchuk-Fried.Executive.Compensation.pdf (last visited October 29, 2003); Bebchuk, supra note 12, at **34.**

commentators in particular have become enamored of the notion that institutional shareholders can and should serve as more active monitors of the public corporation's management and board and should have greater rights to intervene if they are unhappy with what the management or board is doing.[25] We have already noted some of the flaws in the managerial discipline model, on which the perceived need for close shareholder monitoring of boards and managers is based. Even if one assumed that effective monitoring would be a constructive activity, there are natural limits on the ability of institutional shareholders to perform this role, both in terms of their resources and in terms of their inclination to do so.[26]

There are a number of significant issues with relying on institutional shareholders to perform the role of active and ongoing monitors of managerial and director performance. First, it is not their expertise. The analysts and money managers employed by institutional shareholders tend to be trained in financial analysis, not in corporate management. They are trained to analyze the financial results and condition of a corporation and its financial projections in order to make a determination as to whether the trading price of the corporation's shares makes those shares a good buy They are not trained to analyze how best to manage the business operations of the corporation.

Second, they have not invested in the internal resources that would be necessary to serve as effective ongoing monitors of the corporation's management and board, and it is far from clear that it would be in their economic interest to do so. An institutional investor owns only a fraction of the equity interest in a public corporation. Developing the expertise to determine what investments to buy, when to buy them and when to sell them creates a benefit that inures completely to the investor. Developing the expertise to assist in improving corporate management, even if the institutional investor could be successful in doing so, would create a benefit that would inure primarily to others. Moreover, to take an effective role in assisting in the management 'or direction of the company would require access to information that would likely make the investor an insider or, at least, raise questions in this regard. The institutional investor, first and foremost, wants

25. See, *e.g.*, Bernard S. Black, Agents Watching Agents: *The* Promise of Institutional Investor Voice, 39 UCLA L. REV. 811, 813, 817, 819 (1992) (advocating that institutional shareholders should "monitor the actions of corporate managers," that the "downside risk from institutional voice is small,"and that benefits of such "oversight"should outweigh the expected costs); John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 COLUM. L. REV. 1277 (1991); Ronald J. Gilson & Reinier Kraakman, Reinventing the *Outside* Director: An Agenda for Institutional Investors, 43 STAN. L. REV. 863 (1991) (calling on institutional directors to elect directors to engage in monitoring).

26. See Pozen, supra note 16, at 95 (stating "institutional investors are 'reluctant'activists")(citing Robert C. Pozen, Institutional Investors: Reluctant Activists, HARV. Bus. REV., Jan.–Feb. 1994, at 140, 149); Chandler, supra note 16, at 1092 ("[F]rom an efficiency perspective the merit of reliance on institutional investors as corporate monitors is inconclusive. A major problem still persists, as Professor Black coined it, in the form of 'agents watching agents."')(citing Black, supra note 25); see also Roberta Romano, Less is More: Making Institutional Investor Activism a Valuable Mechanism *of* Corporate Governance, 18 YALE J. ON REG. 174, 174, 250–51 (2001) (concluding that despite the history of "commentators' generally positive assessments" of institutional shareholder activism, empirical evidence shows such activism has little or no effect on targeted firms' performance).

to be free to buy and sell at the times of its own choosing. Institutional investors do not want the constraints that would undoubtedly come with an increased role in managerial monitoring.[27]

Third, many institutional and other activist investors have competing interests that may conflict with the best interests of the public corporation and its shareholder body and other constituencies taken as a whole.[28] Different investors have different time horizons. Some may seek to push the corporation into steps designed to create a short-term pop in the company's share price so that they can turn a quick profit. Others may be concerned more with long-term investment and performance.[29] In addition, investors may have competing interests over and above their financial interests as shareholders.[30] For example, labor unions may use shareholder activism as an element of their collective bargaining strategy or to gain leverage over or access to managers in order to advance union-related objectives.[31] Public pension funds may be subject to political pressures that affect the positions they take as shareholders on corporate governance matters.[32] Share-

27. Institutions could also face liability issues with respect to the actions of directors they have nominated. For example, a recent court decision declined to dismiss a case brought against a thirteen percent shareholder that had appointed two directors to the hoard of an internet startup company, alleging that the thirteen percent shareholder had aided and abetted the two directors' breaches of fiduciary duties. CCBN.Com lnc. v. Thomson Fin'l Inc., 270 F. Supp. 2d 146 (D. Mass. 2003).

28. See Chandler, supra note 16, at 1092 ("Just as managers' and shareholders' interests are not always aligned, institutional investors' and individual shareholders' interests may diverge. . . . Another weakness is evident when one examines the various flavors of institutional investors.").

29. Id. at 1093 (describing the divergent short and long-term interests of shareholders); see also Edward B. Rock, The Logic and (Uncertain) *Significance* of Institutional Shareholder Activism, 79 GEO. L.J. 445, 468 & n.73 (1991).

30. See Rock, supra note 29, at 468–72 & nn. 73–101 (1991) (discussing various conflicts of interests institutional shareholders may have apart from their interest as shareholders to maximize financial value of the shares).

31. See Marleen O'Connor, Labor's Role *in* the American Corporate Governance Structure, 22 COMP. LAB. L. & POL'Y J. 97, 113–15 (2000) (describing how unions increasingly are using their power as shareholders of corporations to promote labor, not corporate, ends). O'Connor describes several examples of unions exerting such power, such as

> us[ing] shareholder activism at companies where they are concurrently engaged in contract negotiations or union organizing campaigns [as well as for settling strikes]. By focusing on certain 'wedge' issues that public funds support, unions can gain access to 'behind the scenes' meetings with managers. . . . During these meetings, it is commonly understood among those in the institutional investor community that unions may discuss labor issues, as well as corporate governance matters. If these negotiations proceed favorably, the notion is that the union will withdraw its shareholder proposals.

Id. at 114 (citations omitted).

32. See Rock, supra note 29, at 471–72 & nn. 84–87 ("A public pension manager may be pressured by interest groups within the state that have interests unrelated to, or directly contrary to, the maximization of the value of the fund. Public pension fund managers may also face significant pressures from state and local governments.") (citations omitted); Romano, supra note 19, at 796 (discussing how public pension funds have been looked to as potential leaders of institutional shareholder activism because of perceived conflicts experienced by other corporate pension funds and investors due to business relationships with corporate management but that "public pension funds face distinctive investment conflicts that limit the benefits of their activism," and that, "[p]ublic fund managers must navigate carefully around the shoals of considerable political pressure to temper investment policies with local considerations").

holders with "socialcauses" regularly use governance as a means to promote those causes.[33] Institutional investors will also invariably have investments in a broad range of companies, including competitors, customers, suppliers, etc. Depending on the relative sizes of these investments, their views on how they would have any given company act may be affected by their investments in these other companies.

Shareholder input is obviously important, but it is not and should not be the only input to which directors and managers are obligated to listen. The nature of the public corporation board, and the legal principles that govern it, recognize the need to have a body that balances a wide array of competing interests, both among the shareholders themselves and between shareholders and other constituencies. The directors and officers of the corporation are the only constituency that has legal obligations to act in the best interests of the corporation. Each other constituency—shareholders, creditors, suppliers, customers, etc.—is legally free to act and bargain with the corporation in the pursuit of its own self-interest.[34] Each also has its own legal and contractual rights available to protect that self-interest. The particular rights accorded to shareholders recognize their role as residual risk-takers in the capital structure. For example, shareholders are given the right to approve or reject major corporate life decisions, such as a merger, a sale of all or substantially all the corporation's assets, or an amendment to the corporation's charter. As noted above, shareholders also have a number of other avenues to make their views known and influence corporate decision-making. But it is left to the board to seek to balance all the competing interests of the corporation and to try to ensure the long-term health and success of the enterprise as a whole. Permitting shareholders to use the company proxy statement to run election contests would dramatically shift the balance that has evolved over time, moving firmly towards the flawed principal-agent, managerial discipline model of corporate governance.

33. David Moberg, Union Pension Power: Labor is Mobilizing Its Investment Power to Pressure Corporate America, 266 NATION 16 (June 1, 1998), available at 1998 WL 11637541 (describing how unions are not the only shareholder constituents increasingly using their economic clout to influence corporate management, including to advocate social activism agendas, and noting as an example that "[c]hurch-linked pension funds have for many years used shareholder meetings to raise issues about human rights overseas, discrimination at home and environmental violations"); Klaus Eppler et al., Corporate Governance Activities of *Institutional* Investors and Other Activists (PLI Corp. Law Practice Course, Handbook Series No. B0-01T3, 2003), available at 1353 PLI/Corp 11, at *17 (Westlaw) (describing the traditional use of the shareholder proposal process by churches and other social activist groups to influence corporations as to their social policies, which use now increasingly includes corporate governance issues as well).

34. Some case law suggests that a controlling shareholder does have legal obligations to the other shareholders, though it is not entirely clear that those obligations flow from the controlling shareholder's status as a shareholder or indirectly from and through the controlling shareholder's board nominees. See *e.g.*, Riblet Prods. Corp. v. Nagy, 683 A.2d 37, 40 (Del. 1996) (noting that majority shareholders may owe fiduciary duties to minority Shareholders); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) (noting that a shareholder owes a fiduciary duty to other shareholders if it "owns majority interest in or exercises control over the business affairs of the corporation").

THE ROLE AND PROPER FUNCTIONING OF THE BOARD

The managerial discipline model of corporate governance also ignores some of the most important aspects of the role and proper functioning of a board of directors of a public corporation. Part of the board's role, of course, is to monitor management—to select the chief executive officer and other senior executives, to determine their compensation and, if it becomes necessary, to replace them. The board operates within a set of legal constraints and duties that clearly recognizes this role, and directors can face the threat of legal liability for failing to perform this role.[35] Equally if not more important, however, is the board's role in advising management, in assisting the decision-making process, in improving the operations of the business and in assessing the promise of business opportunities and other transactions. Clearly the board has to be ready to perform its monitoring function when and if required, but the bulk of a board's activity is typically devoted to its advising function. Despite the highly publicized scandals of Enron, WorldCom and others over the last couple of years, management dishonesty or perfidy remains the exception. The vast majority of corporate managers are committed and highly motivated to work towards the success of the corporations they manage. The core issue of corporate governance is not managerial dishonesty, but managerial capability, which is primarily the function of two factors: the manager's intrinsic ability and the tools and support the manager is given by others. Replacing a chief executive officer or other senior executive, although necessary on occasion, is usually not an optimal solution. It can be disruptive to the corporation, and there is no assurance that the replacement will be better. The corporation, its shareholders, and its other constituencies are thus better served if the board can work with existing management to improve the operations and performance of the corporation, rather than starting over with new managers.[36]

In order for a board to perform its advisory role effectively, there must be a level of mutual respect and trust between the corporation's directors and managers, as well as among the directors themselves. This is true for a number of reasons. First, directors rely on the company's management for access to information. When the executives view directors as being "on the same side," i.e., when they believe the directors are primarily interested in helping improve the operations of the company, the executives are likely to volunteer more and better information in the interest of getting better advice. In theory, of course, directors are entitled to whatever information they believe is necessary and can ask for that

35. See *In* re The Walt Disney Co. Derivative Litig., 825 A.2d 275, 277–78, 282–89 (Del. Ch. 2003) (denying motion to dismiss derivative action brought by shareholders of The Walt Disney Company against its board of directors, in which action shareholders allege that the directors breached their fiduciary duties in approving a generous employment agreement for then president Michael Ovitz and by "impliedly" approving a "non-fault termination" for Ovitz that resulted in Ovitz receiving severance compensation of approximately $140 million). The Chancery Court held that the allegations of the shareholders if taken as true "imply that the defendant directors *knew* that they were making material decisions without adequate information and without adequate deliberation" and further that the directors alleged "conduct fell outside the protection of the business judgment rule." Id. at 289 (emphasis in original).

36. See Renee B. Adams, The Dual *Role of* Corporate Boards as *Advisors* and Monitors *of Management: Theory and Evidence*, Mimeo, Federal Reserve Bank of New York.

information to be provided. But it is simply human nature for an executive to respond differently in a relationship of mutual respect than in an adversarial relationship. In the latter situation, the information will be formulated and packaged more defensively and more formally in an effort to fend off the perceived possibility that it will be used to attack management rather than to assist them. Second, executives are far more likely to listen to advice from directors they respect and trust than from directors they view as adversaries. Again, this is simply human nature. The natural reaction in an adversarial relationship is to be defensive and to try to erect barriers against the adversary Third, it is far more likely that the directors themselves will be able to work with each other to assist corporate decision-making if they respect and trust one another. In this environment, directors will feel comfortable discussing and debating the merits of business decisions, opportunities, and corporate policy and direction. In an environment where the directors are divided into warring factions, this kind of open discussion and debate simply does not take place. Instead, subgroups of directors conduct rump sessions and sidebar discussions in an effort to outmaneuver the opposing faction or factions. In the process, the effectiveness of the boards business advisory function is severely compromised. It should also be noted that the board's monitoring function is hurt when an adversarial relationship develops among the directors or between the directors and management. The access to information and ability to interact openly with management and other directors gives the board greater insight into management's performance, allowing the board to make its monitoring decisions more intelligently and effectively as well.

For these reasons, boards of directors of public corporations have typically tried to cultivate a collegial relationship, seeking to achieve a consensus in their decision-making. Critics, of course, would argue that the relationship can become too collegial and that the collegial environment can undermine the board's independence and monitoring function. Although this criticism may in some instances have some merit, the solution is not to destroy the collegiality of the board but rather to strengthen the boards independence and encourage a greater focus on the monitoring function. Indeed, this approach has been the goal of regulation and legal developments in the last decade or two, particularly in the most recent round of reforms. Public boards of directors are now virtually uniformly comprised of a majority of independent directors, and in most cases independent directors comprise the vast majority The major board committees—audit, nominating and governance, and compensation—are typically comprised entirely of independent directors, and under the new rules this is a requirement. Case law in Delaware and elsewhere has raised the specter of legal liability when directors abandon their monitoring responsibilities, a development that has further heightened the sensitivity of directors to focusing on this function.[37] Moreover, the concentration of share ownership in the hands of major institutional shareholders continues to increase the sensitivity and responsiveness of directors and managers

37 *See* Guttman v Huang, 823 A 2d 492, 506 (Del Ch 2003); In re Caremark Int'l, Inc Derivative Litig , 698 A 2d 959, 968-70 (Del Ch 1996)

to the views of these shareholders There are some who would argue that the balance has already tipped too far, but these new reforms hold the promise of further improving the operation of the public company board without destroying the board's collegial environment

THE COSTS OF ELECTION CONTESTS

The benefits of facilitating more election contests, and the nomination and election of more dissident directors, are doubtful. In contrast, the costs of doing so are numerous. Election contests today are a last resort, but they do occur. And they occur with sufficient frequency that directors and managers remain mindful of them. At the same time, election contests also carry significant costs that must be balanced against whatever "disciplining" benefits they may confer in any given instance. Our current system has developed gradually, striking a balance between the goals of encouraging board independence and monitoring and the goals of giving the board the ability to perform its advisory function effectively and giving directors and managers the ability to make business decisions that take into account the long-term interests of the corporation and all its constituencies. For adherents of the shareholder as owner, principal-agent, managerial discipline model, of course, the paramount concern is to ensure that directors and managers conform their actions to the wishes of the shareholders. Given the flaws in this model, however, there is little reason to assume that following it blindly would benefit the health and success of our public corporations and our economy generally Instead, we must consider the costs of facilitating election contests and electing dissident directors, assess the other means that have developed over time, and that continue to be developed, to encourage board independence and the monitoring function of the board and determine where the right balance lies.

SPECIAL INTEREST DIRECTORS AND BALKANIZATION OF THE BOARD

It is hard to appreciate fully the impact that the addition of special interest or dissident directors has on the operation of a board until one has experienced it firsthand, When it occurs, the board is essentially split into multiple boards. The full board, of course, still gathers for formal meetings, but the collegiality of the board is typically destroyed, inhibiting the open discussion and give and take of a well-functioning board where the members trust and respect each other. Instead, in addition to the formal meetings of the full board, informal meetings of subgroups of directors occur to develop separate strategies and discuss how to deal with the other factions. The board becomes politicized and balkanized. Similarly, to the extent the senior executives do not trust and respect one or more of the directors and some directors are viewed as adversaries rather than partners, the relationship between the board and the management can also break down. At a minimum, the executives will become more defensive, more formal, more careful and less open in dealing with the directors they view as adversaries and with the full board when it convenes as a whole. All of these reactions are destructive to the boards ability to perform both its business advisory role and its monitoring role.

When the dissident directors view themselves as representing particular special interests, such as labor unions, political bodies, social activists, or some other subset of the shareholder population, these problems are exacerbated. This is because the dissident director's connection to the special interest, and the director's sense of responsibility to represent that interest, reinforces the balkanization that arises from the introduction of dissident directors generally It also decreases the possibility that, over time, the dissident director or directors can reach accommodations with the rest of the board that allow the board to reunify and function again as a more collegial body Directors who are aligned with a special interest are far less likely to have an open mind with respect to other directors' views as to the best interests of the corporation when those views are at odds with the special interest views. Conversely, the other directors are far less likely to have an open mind with respect to the views of the dissident director if they view that director as beholden to a special interest.

There is no question that giving shareholders access to the corporate proxy machinery to run an election contest would facilitate the nomination and election of dissident and special interest directors. Special interest groups tend to dominate the Rule 14a-8 arena and are at the most activist end of the shareholder spectrum.[38] Although the current election contest proposals are more restrictive than the Rule 14a-8 process, special interest groups are likely to be at the forefront of those seeking to use the company's proxy to run election contests if these proposals are adopted. Given that the primary point of these proposals is to make running an election contest far easier than it is today, it is inevitable that if the proposals are adopted, the rate at which dissident and special interest directors are nominated and elected will be far greater than it is today

Disruption and Diversion of Resources

An election contest is a tremendously disruptive event for a company Given the centrality of the board to the business operations and direction of a company and the impact of adding dissident and/or special interest directors to a board, a company typically devotes a significant amount of resources and time to explaining why the board-nominated slate should be elected when it faces a contested election. Fighting an election contest thus diverts large amounts of management

38. See John C. Wilcox, The Growing Importance of Institutional Investors and Equity *Analysts for the M & A Agenda* (PLI Corp. Law Practice Course, Handbook Series No. B4-7179, 1997), *available* at 973 PLI/Corp 567, *574–*77 (Westlaw) (noting that "the air of legitimacy which attached to institutional activism has been co-opted by other proponents, including labor unions, grassroots organizations, and others traditionally categorized as gadflies," that "one of the unpredicted consequences of the amended [shareholder] communications rules has been to stimulate activity by gadflies, who now numerically dominate Rule 14a-8 shareholder proposals," and that the "proxy process has arguably been trivialized as special interest groups resume the dominant role sponsoring shareholder proposals").

time and attention from the operation of the business, as well as potentially imposing significant monetary costs for the printing and mailing of proxy materials and supplements and the assistance of outside advisors. Under the current system, election contests at public companies are a last resort. They do occur, but they are the exception rather than the rule. If shareholders are able to use the company's proxy statement to run an election contest, the frequency of election contests, and all the disruption they entail, will increase significantly Indeed, that is the central intent of these proposals.

Shareholders' use of Rule 14a-8 to submit proposals for inclusion in the company's proxy statement has been increasing steadily in recent years. Over 900 Rule 14a-8 shareholder proposals have already been presented at annual meetings in 2003.[39] Although the SEC's proposed director nomination rules set a higher threshold for using the company's proxy statement to run an election contest than the threshold for submitting a Rule 14a-8 proposal, public companies could still face hundreds of election contests each year if the rules are adopted. The resulting disruption and diversion of resources would be significant and destructive, hurting companies and all their constituencies.

In addition, the SEC's third potential trigger for granting shareholders the ability to use the company's proxy statement to run an election contest would create a separate, though perhaps unintended, disruptive threat. As noted above, the SEC is seeking comment on the possibility of a triggering event based on the failure of a company's board to abide by a majority shareholder vote on a Rule 14a-8 proposal.[40] As a practical matter, such a triggering event would simply confer increased power on Rule 14a-8 proponent and encourage an increased number of Rule 14a-8 proposals. Currently, a board will consider seriously and carefully the views of shareholders as expressed in a majority vote on a Rule 14a-8 proposal, but it is still the board's responsibility to determine what the board believes in good faith to be the corporation's best interests. The board has a fiduciary obligation to make its own determination as opposed to complying automatically with the results of the shareholder vote. If the third trigger is adopted, however, the failure to comply with the vote on the Rule 14a-8 proposal would open the company's proxy statement to shareholder election contests and all the adverse effects that may entail. Even if the SEC only adopts the two triggers it has currently proposed, there may still be an individual increase in the pressure to implement any Rule 14a-8 shareholder proposal that receives a majority vote. This is because the company may otherwise face a campaign to withhold authority for the election of one or more directors, which would separately trigger the access regime under the SEC's proposed rules if at least thirty-five percent of the shares vote in favor of withholding authority Most proponents of giving shareholders greater say in the nomination and election of directors do not go so far as to suggest that the corporation should be run by shareholder plebiscite. Yet this is

39. Morrow & Co., Inc. Proxy Update, at *2* (April 2003) [hereinafter Morrow & Co.]
40. Proposed Rule: Director Nominations, **supra** note 1.

exactly the direction that the SEC's proposed rules and the potential third trigger threaten to take us.

CREATION OF ADVERSARIAL RELATIONSHIPS

The hostile takeover era of the 1970s and 1980s created an unhealthy atmosphere of tension and distrust between shareholders and managers. Many shareholders supported hostile takeover activity for the premiums and quick profits it brought and accused managers who sought to defend their companies of entrenchment and self-interest. Conversely, managers came to view shareholders who supported the hostile takeover activity as the "enemy" and treated them cautiously and warily The ability to establish constructive dialogue between the two, for each to communicate their views effectively to the other, obviously suffered. Since the decline of hostile takeover activity at the end of the 1980s, however, shareholders and managers have slowly developed better and more constructive lines of communication. Increasingly, large shareholders came to the conclusion that their ability to influence the direction of the corporation would be greater if they engaged in dialogue rather than accusations.[41] With the ever-increasing concentration of share ownership in institutional hands, managers increasingly recognized the importance of developing stronger relationships and better communications with their major shareholders. The proxy communications reforms of 1992, the greater focus on the independence and proper functioning of the board, and the removal of the constant friction generated at the height of hostile takeover activity, all facilitated a more constructive relationship,

A significant increase in election contests, however, would threaten to slow this progress and reintroduce the kind of adversarial relationships spawned by the hostile takeover era. Seeking to replace one or more directors on a company's board is an intrinsically adversarial act, and companies and boards that find themselves subject to election contests react to it as such. To the extent that election contests become a common occurrence in the corporate landscape, the way hostile takeovers became common at the height of the hostile takeover era, this adversarial environment is likely to infect even those companies that are not direct targets. There is no question that large shareholders have become more influential over the last decade, and the latest round of reforms will likely continue this trend. For the most part, however, the increased influence has been accompanied by a more cooperative relationship between shareholders and managers than existed during the hostile takeover era. The attempt to tip the balance further by promoting election contests threatens to slow or reverse this progress and recreate the "war mentality" that existed during the 1970s and 1980s.

41. See John Haberstroh, *Activist* institutional Investors, Shareholder Primacy, *and* the *HP-Compaq* Merger, 24 HAMLINE J. PUB. L.& POL'Y 65, 95 (2002) (recognizing that efforts at corporate monitoring and activism by institutional shareholders and others during the 1990s has supplanted the attempted use in the 1980s of hostile takeovers to pressure corporate managers).

IMPACT ON DIRECTOR RECRUITING AND INCREASED AVERSION TO RISK

An increase in the incidence of election contests will also exacerbate the problems that have already arisen in recruiting and retaining high quality directors for the boards of public corporations. The best candidates for director typically do not need the job. They are individuals who have already achieved a high level of success professionally and financially. They are not dependent on the fees they are paid as directors. Rather, they serve for the interest and challenge of contributing their skills to the successful operation and direction of the company, for the opportunity to interact and share ideas with other successful executives and professionals and for the prestige of being part of a successful business operation. Given these motivations, the best candidates do not need to be constrained or disciplined; their reasons for serving as directors are tied to and dependent on the business success of the corporation on whose board they serve.

A number of developments have begun to create problems in recruiting the best candidates for director. First, the public prestige of being a director has been undermined by the scandals of Enron, WorldCom and others, and the attendant publicity and criticism surrounding these scandals. The misdeeds of a few have translated into a skepticism and public distrust that affects all directors. Second, the array of reforms and new rules and regulations adopted over the last year has imposed a substantial procedural burden on public boards of directors. Many of these reforms hold the promise of improving the effectiveness of corporate governance in the long run. But the initial implementation of such a large number of new requirements, particularly in an environment in which companies are encouraged to err on the side of conservatism and additional process, has left many boards spending substantial amounts of time on new procedures that can sometimes appear unproductive to them. Third, recent court decisions have created the perception that directors may be facing an increased exposure to personal liability This may turn out to be more perception than reality, and the business judgment rule clearly remains intact. In the context of increased public criticism and increased procedural burdens, however, the perception of increased liability exposure is one more reason for the best director candidates to say "no thank you." In this environment, it is easy to see how the prospect of facing election contests on a regular basis could be the nail in the coffin for director recruiting.[42]

A related problem is the issue of excessive risk aversion on the part of corporate directors and managers. The effective operation of a business enterprise requires

42. An article in The Economist observes, "[t]here is now no quicker way for an American boss to empty the 19th hole at his local golf club than to ask: 'Would anyone like to serve on my board?'" Cleaning Up the Boardroom—America has *Sarbanes-Oxley*. Britain has Derek *Higgs*, THE ECONOMIST, Nov. 2, 2002, at 66, available at 2002 WL 7248077 [hereinafter Cleaning Up the Boardroom]; see also Fortune *1000* Board Members Are Turning Down Directorships at Twice the Rate of Last Year Due to Personal Liability *Risk*, BUSINESSWIRE, Oct. 28, 2003, at *1 (describing an annual study conducted by Korn/Ferry International, a management search services company, that found that twenty-three percent of directors on boards of Fortune 1000 companies in the Americas turned down additional board roles in 2002 in contrast with only thirteen percent of such directors turning down board positions in 2001).

that directors and managers incur risk. A well-run company, of course, will be prudent about the risks it incurs, and will carefully consider and weigh the expected benefits of any business decision against the risks entailed in that decision. An excessive aversion to risk, however, is as dangerous to the business enterprise as excessive risk-taking. To the extent that directors feel under public pressure, under governmental and regulatory pressure, and exposed to a heightened risk of personal liability, they will naturally become more cautious.[43] Some commentators believe that the level of risk-aversion engendered by the reforms that have already been adopted to date is having an adverse impact on our corporations and our economy.[44] The prospect of facing election contests on a regular basis can only be expected to increase that risk-aversion.

DISCLOSURE ISSUES

Requiring someone who wants to conduct an election contest to file separate proxy materials serves the central purpose of the proxy rules, namely assuring full disclosure and accountability This requirement also avoids the logistical difficulties and confusion that would result from having more nominees on a single proxy card than there are seats and from having nominees opposing the company's slate listed in the company's own proxy statement and card The SEC has long recognized the importance of disclosure, clarity, and accountability in the context of an election contest, and the proxy rules contain special provisions and require enhanced disclosure for such contests The rules recognize that the election of directors goes to the core of the company's governance and that shareholders need full and detailed disclosure about director candidates as well as the parties that are proposing and soliciting proxies for those candidates These rules are not

43 See, *e.g.,* William T. Allen et al., Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A *Critique* of "Van Gorhom" and Its Progeny as a Standard of Review Problem, 96 NW. U. L. REV. 449, 452 (2002) (noting that "if the risk of liability is disproportionate to the directors' incentives for service, directors may avoid making economically valuable decision that might subject them to litigation risk"); Stephen M. Bainbridge, Why a Board? Group Decisionmaking in Corporate Governance, 55 VAND. L. REV. 1, 50–51 (Jan. 2002) ("Shareholder litigation encourages directors to be risk averse. In turn, risk-averse directors take excessive precautions and avoid risky decisions.").

44. Adrien Michaels, Comment & Analysis: Taking Internal *Strife* Out of the Headlines, FIN. TIMES, Jul. 24, 2003, at 11 (interview with SEC Chairman William Donaldson in which Donaldson "for the first time . . is siding with those who argue that the [recent corporate governance] crackdown is stifling entrepreneurialism, paralysing [sic] boardroom decisionmaking"); Frank Balotti, Rush *to Judgment*, THE DAILY DEAL, May 21, 2003, available at 2003 WL 4168722 ("One of the most troublesome consequences of the tremendous increase in pressure on boards," including significant increase in exposure of directors to being judged in hindsight, is the concern "that directors will become increasingly risk averse, which inevitably will lead to a hard-to-detect, but real, decline in entrepreneurial risk taking."). Balotti further notes: "State corporate law is a product of years of consideration and refinement and should not be preempted or swept aside without careful thought."Id.; Cleaning Up the Boardroom, supra note 42 (discussing complaints about rushed overreaching by legislators, regulators, and prosecutors in the area of corporate governance in the wake of Enron and other "spectacular business failures" and corporations' fear that the result "will be boardrooms paralysed [sic] by red tape and non-executive (outside) directors turned wholly risk-averse by legal advice on how to avoid being sued into poverty should their firm ever fail").

anti-democratic, nor do they preclude shareholders from nominating and soliciting proxies for director candidates of their choosing. Rather, they simply require added disclosure for election contests, clear identification of soliciting parties and pre-filing of proxy materials in contested elections.

As we note above, unlike the company's board and nominating committee, shareholders have no fiduciary duties to the company or other shareholders and corporate constituencies. They may nominate director candidates for any number of purposes, regardless of whether those purposes are self-interested or designed to promote other agendas. For this reason, issues of full disclosure and accountability with respect to shareholder nominees are of paramount importance. Requiring a shareholder who nominates a director candidate to file and take responsibility for his or her own proxy statement allows a level of scrutiny, disclosure and accountability that an insert in the company's proxy statement is not able to provide.

Moreover, the expense and burden of requiring separate proxy materials is vastly overstated by those who would enable shareholders to run an election contest through the company's proxy statement. Under the current rules, election contests using separate proxy materials are conducted even by individual shareholders. If shareholders were allowed to use the company's proxy statement, presumably the level and extent of required disclosure would not be less than required in the separate proxy materials, so the burden of preparing these disclosures would be the same. However, the clarity and accountability that comes with separate proxy materials would be compromised. Even if requiring separate proxy materials for an election contest does impose some marginally greater burden, the disclosure and accountability benefits far outweigh any cost.

THE PROMISE OF RECENT REFORMS

A primary focus of the far-reaching reforms adopted over the past year is the continued improvement of public company governance and the operation of public company boards The Sarbanes-Oxley Act and the recently adopted NYSE and Nasdaq rules strengthen the standards of independence for directors, require a majority of the board to consist of independent directors, require key committees—audit, governance/nominating and compensation—to consist entirely of independent directors, and impose even stricter standards for members of the audit committee They also mandate expanded powers and responsibilities for the members of these committees, such as the requirement that the audit committee set the terms and compensation of the company s auditors or the requirement that companies pay for outside advisors that the committee wants to hire[45] In addition, the new rules require companies to adopt and publicly disclose codes of conduct and ethics governing directors, officers, and other employees, as well as committee

45. Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, 775–76 (2002).

charters and corporate governance guidelines.[46] They require the independent directors to hold executive sessions on a regular basis.[47] They mandate internal mechanisms for reporting and responding to evidence of wrong-doing.[48] The recently adopted NYSE rules require companies to disclose means by which shareholders may communicate with the independent directors.[49]

Although many well-run companies already followed policies and practices that mirrored some of the new rules, the scope and range of the new requirements are having an impact on all companies. Together with the ever-increasing focus on corporate governance that predated the new rules, the high concentration of institutional share ownership and earlier reforms such as the SEC's 1992 proxy rule amendments, the new regulatory framework is already ensuring that every public company is keenly focused on corporate governance issues and board processes and procedures. The new framework is also almost certain to continue the trend of the last decade towards increased sensitivity and responsiveness on the part of directors and managers to shareholder input. It is too early to know, of course, the full impact of the reforms mandated by the Sarbanes-Oxley Act and the new stock exchange rules. Some commentators argue that the new regulatory framework goes too far and is having a damaging effect on our public corporations, although others argue that the reforms do not go far enough and more is needed.[50] But there is no question that the Sarbanes-Oxley Act and the new stock exchange rules have had, and will continue to have, a significant impact on how public companies are run. Before racing to adopt new far-reaching and substantial changes to our corporate governance system, it seems only prudent

46 See Sarbanes-Oxley Act 116 Stat at 755–56 (requiring disclosure by a public company whether it has a code of business conduct and ethics and if not, why not), NYSE Final Rules, supra note 2 (recently adopted Section 303A(1) of the NYSE's final Listed Company Manual rules require companies listed on the NYSE to adopt and disclose a code of business conduct and ethics Section 303A(9) requires listed public companies to adopt and disclose corporate governance guidelines, and Sections 303A(4)–(6) require listed companies to adopt charters for nominating, compensation and audit committees), NYSE and Nasdaq Final Rules Approval, supra note 2 (recently adopted amendments to Nasdaq's Rule 4350(c)(3)–(4) require quoted public companies to adopt nomination and audit committee chapters)

47 See NYSE and Nasdaq Final Rules Approval, supra note 2 (recently adopted amendment of Nasdaq's Rule 4350(c)(2)); NYSE Final Rules supra note 2 (recenlty adopted Section 303A(3) of the NYSE Listed Company Manual)

48 Sarbanes-Oxley Act, 116 Stat at 750

49 See NYSE Final Rules, supra note 2 (recently adopted Section 303A(3) of the NYSE Listed Company Manual)

50 See supra note 44 and accompanying text, see also Deborah Solomon, *Sarbanes* and *Oxley* Agree to Disagree, WALL ST J , Jul 24, 2003, at C1 (recounting Rep Michael G Oxley's recently stated concerns that the Sarbanes-Oxley Act has 'produced some unintended consequences" such as perhaps making companies risk-averse and overly fearful of tripping its provisions); *cf. Staff* Report Review *of* the Proxy Process, supra note 17, at Appendix A (noting in the summary of responses to the SECs request for comments regarding potential reforms to the proxy process that '[a]lthough many of [the] commenters acknowledged the importance of current initiatives under the Sarbanes-Oxley Act of 2002 and the markets amendments to listing standards in addressing director conflicts of interests, a majority were of the view that greater accountability of board members to shareholders was a necessary step in addressing these systemic issues")

to take the time to assess the impact of the far-reaching reforms that have just been adopted.

THE NEW REFORMS

A very substantial number of the provisions of the Sarbanes-Oxley Act and the new stock exchange rules address the composition, independence, and qualifications of the public company board of directors, precisely the same issues as the proposals to permit shareholders to run election contests through the company's proxy statement seek to address. The new stock exchange rules provide that a majority of the board—and all the members of the audit, governancehominating and compensation committees—must be independent and establish standards for when a director is deemed to be independent. These rules provide that a director may not be considered independent unless the board of directors affirmatively determines that the director has no material relationship with the company. The rules also specify certain relationships that automatically or presumptively disqualify a director from being considered independent. The board's determinations as to independence must also be publicly disclosed. Under Sarbanes-Oxley, the requirements for membership on the audit committee are even more stringent. No audit committee member may receive any direct or indirect compensation from the company except for directors' fees. In addition, no audit committee member may be an affiliated person of the company Companies are also required to disclose whether at least one member of the audit committee is a financial expert, as that term is defined by SEC rules.

The new requirements with respect to board and committee composition and independence are forcing every public company to reexamine its board and committees and to reassess the appropriate composition of each. Some companies have rearranged or plan to rearrange their committee memberships in light of the new rules. Other companies are recruiting additional directors to enhance the level of board independence and/or ensure a greater level of financial expertise for the audit committee. Companies are also reexamining their relationships with their outside directors in order to determine whether there are any relationships that could, or could appear to, compromise the directors' independence or effectiveness. Even in cases where board or committee composition is not changed, the relationships the company has with the directors may be reassessed. In all events, the new requirements are leading companies to focus on their boards, committees and director relationships in an effort not only to comply with the rules but also to determine whether there are ways to improve or enhance the board's composition and structure.

In addition to composition and independence, the new requirements also address the proper functioning of the board and its committees. The recently adopted stock exchange rules require companies to adopt and disclose corporate governance guidelines for the company as a whole and committee charters for the company's audit, governance/nominating, and compensation committees. These rules establish minimum requirements for the matters that companies must address in these guidelines and charters. As with the rules relating to composition and independence, the rules mandating governance guidelines and committee charters are forcing companies to reassess and, if necessary or desirable, change the way the board and its committees operate. The requirement that independent directors meet periodically in executive session is yet another example of required changes in the manner in which boards and directors operate.[51]

There is no doubt that the new regulatory framework will have a significant impact on our public companies. There is reason for hope that, in combination with prior reforms and changes in the governance environment, the new rules will be effective in improving these companies' corporate governance practices, increasing the quality and independence of boards of directors, encouraging even more diligence and director scrutiny of companies' business operations and management actions, and minimizing the possibility of future lapses similar to those experienced by Enron, WorldCom and the like. Although the level of success of these rules in meeting these goals is still to be seen, the new framework certainly shows promise in focusing companies on all aspects of their corporate governance practices.

PRIOR REFORMS AND TRENDS

Even before the adoption of the new regulatory framework imposed by the Sarbanes-Oxley Act and the new stock exchange rules, a number of prior reforms and trends were already increasing shareholder input and director and manager responsiveness. The most important of these were the increased concentration of institutional ownership in public companies, particularly our largest companies, and the SEC's 1992 proxy rule amendments enhancing shareholder communications. In most large public companies today, institutional shareholders hold a majority of the shares. In many cases, they hold a substantial majority As of the third quarter of 2002, institutions held 49.8% of U.S. equities.[52] This concentrated ownership gives them significant potential power over these corporations. In addition, in 1992, the SEC adopted a wide range of proxy rule and other amendments designed to enhance shareholder communications, both amongst shareholders and between shareholders and companies. The 1992 amendments also changed the proxy rules to permit "short slate" election contests, i.e., contests in which the dissidents nominate less than a full slate of directors for election.[53]

51. See Self-Regulatory Organization, Exchange Act Release No. 34-47516, 68 Fed. Reg. 14,451, 14,453-54 (Mar. 17, 2003).

52. NYSE Data Fact Book Online, at http://www.nysedata.com/factbook/viewer-edition.asp?mode=table&key=108&category=12 (last visited October 13, 2003); see also Symposium, *The* Institutional Investor's *Goals for* Corporate *Law* in the Twenty-First Century, 25 DEL. J. CORP. L. 35 (2000). Dr. Carolyn Brancato, a director of the Global Corporate Governance Research Center of the Conference Board estimates that institutions control "nearly half of the U.S. equity market." Id at 38. Another source indicates that institutions own approximately sixty-six percent of the outstanding shares of S&P 500 companies as of January 2003. See Norbert Michel, Most Stocks Are Held by Private Investors, The Heritage Foundation (April 18, 2003) (citing Standard & Poor's Compustat database), *available* at http://www.heritage.org/research/taxes/wm265.cfm?renderforprint=1

53. See Regulation of Communications Among Shareholders, Exchange Act Release No 34-31326, 52 SEC Docket 2028, 2048-49 (Oct. 16, 1992).

The combination of concentrated institutional ownership and more liberal shareholder communications rules also coincided with an improving relationship between shareholders and managers generally With the decline of hostile takeover activity at the end of the 1980s, the war mentality that had often characterized the shareholder-management debate began to dissipate. Shareholders began to recognize increasingly that their interests were better served by trying to work cooperatively, or at least not contentiously, with management towards common goals, i.e., the business success of the company.[54] At the same time, managers began to recognize that the concentrated institutional ownership in their companies made it all the more important for them to try to develop a better relationship with these large holders and to explain the company's business strategy more effectively

EXISTING AVENUES FOR SHAREHOLDER INPUT

These prior reforms and trends have given shareholders a number of constructive avenues to have meaningful input into all aspects of a public company's corporate governance practices, including the nominating and election process. The new regulatory framework can only be expected to expand and enhance these avenues. Most public companies today are very receptive to input from major shareholders. Senior management is generally open to meeting with large shareholders to discuss their ideas and concerns, and often management affirmatively seeks out such meetings. Not infrequently, a company will adopt an idea or proposal brought to it by a large shareholder when the company decides, based on these discussions, that the idea or proposal makes sense for the company and its shareholders. Evidence of this trend may be found in the many cases where a large shareholder withdraws a Rule 14a-8 proposal or decides not to submit it in the first place, as a result of an accommodation reached with the company directly in discussions between the parties.[55] The recent reforms, with their emphasis on independence and board process and, in the case of the new NYSE rules, their requirement that companies disclose a means for shareholders to communicate with outside directors, will likely increase the level and effectiveness of this type of shareholder input.

The new rules governing the independence and operation of the public company's nominating committee will also enhance the ability of major shareholders to provide meaningful input into the nomination process. Encouraging input

54. See, *e.g.*, Stuart L. Gillan and Laura T. Starks, A Survey *of* Shareholder Activism: Motivation and Empirical Evidence, 2 CONTEMP. FIN. DIG. 10, 14–15 (Autumn 1998) (noting for example that in "the early 1990s, the public pension funds initiated changes in the way they approached activism," that "[o]ne such change involved submitting fewer proposals in favor of initiating a dialog with corporate representatives" and that another survey found that "activist institutions preferred direct negotiation to proxy proposals").

55. See Steven A. Rosenblum, The Shareholder Communications Proxy Rules and Their Practical *Effect on* Shareholder Activism and Proxy Contests, in A PRACTICAL GUIDE TO SEC PROXY AND COMPENSATION RULES 11-1, 11-18 (Amy L. Goodman & John F. Olson eds., 3d ed. 2002) (citing the vast majority of TIAA-CREF shareholder proposals that have been withdrawn during the period from 1992 to 2001 as a result of direct negotiations with the target company).

through the company's own nominating committee is likely to be more productive than facilitating a greater number of separate shareholder nominees and a greater incidence of election contests. In determining the nominees for election to the board, as in other actions taken by directors of a public company, the members of a public company's nominating committee and board are subject to fiduciary duties to act in good faith in what they believe to be the company's best interest. Shareholders are not subject to the same duties in proposing director nominees, nor is there a mechanism to ensure that shareholders nominate well-qualified candidates. Thus, the best route for shareholders to influence the nominating process is to propose nominees to the company's nominating committee, which should take bona *fide* nominee proposals from shareholders seriously The nominating committee can then consider these proposed nominees together with other potential candidates from the vantage point of the best interests of the company and its shareholders as a whole. Acting within the framework of its fiduciary duties and the new stock exchange rules, the nominating committee is in the best position to ensure that strong candidates with fresh views and diverse backgrounds may be added to the board. Moreover, encouraging large shareholders to work cooperatively with the company with respect to board nominees reduces the likelihood that the relationship between shareholders and directors or managers will revert back to the adversarial and destructive relationship that marked the hostile takeover era.

Finally, to the extent these avenues prove insufficient in the extreme case, and the threat of an election contest is seen as a necessary last resort, running an election contest through separate proxy materials in fact is already a viable alternative and a viable threat under the existing rules. Running an election contest is obviously not as easy under the existing rules as bringing a Rule 14a-8 shareholder proposal. Nevertheless, shareholders do run election contests on a regular basis under the existing rules, and, increasingly, they run these contests outside the takeover context. Last year, there were forty election contests, many of which were outside the context of any takeover bid.[56] As noted above, the SEC's 1992 proxy rule reforms have made election contests easier by permitting shareholders to run a short slate. In recent years, the majority of election contests have been short slate contests, and a majority of those contests have resulted in either the successful election of the shareholder nominee(s) or a negotiated settlement with the company In addition, the mere threat of an election contest has often been enough to push a company to negotiate with shareholders and agree on one or more mutually acceptable board nominees.[57] Successful contests have been run

56. See Morrow & Co., supra note 39, at 2 (noting that "throughout all of last year [2002], there were approximately forty proxy contests for the election of directors, a number which has roughly stood constant for the past twenty years").

57. See Ronald Grover. *Mattel:* A Great Deal of Re-Assembly Required, Bus. WEEK, Apr. 17, 2000, at *58* (describing Mattel's decision to add a representative of a significant stockholder to the board instead of facing a short-slate proxy fight mounted by that stockholder); David Shabelman, Celeritek Board Adds Dissidents, THE DAILY DEAL, May 20, 2003, at 1, 8 (describing Celeritek Inc.'s recent agreement, in the face of a proxy fight mounted by dissident shareholders that sought to remove and replace Celeritek's entire board, instead to reconstitute the board to consist of three of the dissident share-

not only by institutional shareholders, but by individuals as well, undercutting any argument that there are insurmountable shareholders to an election contest To the extent the threat of an election contest is necessary to keep a company's nominating committee and board "honest,"that threat is very real today Indeed, given the policy reasons why an election contest should be a last resort, rather than a first, one could argue that the SEC should make it harder to run such a contest, not easier

CONCLUSION

Those who would give shareholders the ability to use the company's proxy statement to run an election contest do not make a compelling affirmative case as to either the need for or the benefit of such a radical proposal. Instead, they posit shareholder voice and shareholder control as an end in and of itself—the more, the better. After all, they argue, shareholders own the company, so what they say should control. Directors and managers are agents of the shareholders, the argument continues, so they should do what the shareholders tell them to do or be replaced by others who will. As we have demonstrated, however, the shareholder as owner, principal-agent model is a flawed model as applied to the modern public company. It does not provide an affirmative basis for the adoption of these election contest proposals. In contrast, the costs of adopting such a proposal are real and substantial. In the context of a newly adopted regulatory framework that is already designed to address the issues of board composition and director performance, the adoption of proposals to facilitate election contests is an unwarranted step that offers little apparent benefit and threatens significant harm. As it has in the past, the SEC should weigh these costs against the absence of any clear benefit and reject these proposals. At a minimum, consideration of these rules should be deferred until the impact of the provisions of the Sarbanes-Oxley Act and the recently adopted stock exchange rules addressing the same issues can be fully understood and assessed.

holders' director nominees, three of the incumbent board members, and a new independent outside director).