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**Comment Letter: Private Ordering and the Proxy Access Debate**

January 19, 2010

VIA E-MAIL

Ms. Elizabeth M. Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090  
rule-comments@sec.gov

*Re: File No. S7-10-09  
Release No. 33-9086  
Facilitating Shareholder Director Nominations*

Dear Ms. Murphy:

We welcome the opportunity to submit comments with respect to Facilitating Shareholder Director Nominations; Proposed Rule; Release No. 34-60089, 74 Fed. Reg. 29,024 (2009). We are submitting this comment in our individual capacity; our institutional affiliation is noted for identification purposes only.

We would like to submit as a comment in response to the proposal our attached paper, Private Ordering and the Proxy Access Debate. The paper, which was issued as a Discussion Paper of the Harvard John M. Olin Center for Law, Economics, and Business in November 2009, will be published by *The Business Lawyer* in its February 2010 issue.

Opponents of the proposal have argued that, even assuming that proxy access is desirable in many circumstances, the existing no-access default should be retained, and the adoption of proxy access arrangements should be left to opting out of this default on a company-by-company basis. Our analysis, however, identifies strong reasons against retaining no-access as the default and relying on private ordering to produce access arrangements. In particular, we provide a detailed analysis of the impediments to shareholders' obtaining access arrangements when no-access is the default, and we put forward empirical evidence indicating that such impediments are substantial.

In case additional information about the analysis carried out and evidence put forward in the attached paper could be useful in any way to the deliberations of the staff or the Commission, please contact Lucian Bebchuk at [bebchuk@law.harvard.edu](mailto:bebchuk@law.harvard.edu) or Scott Hirst at [shirst@law.harvard.edu](mailto:shirst@law.harvard.edu).

Sincerely yours,



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Lucian A. Bebchuk



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Scott Hirst

cc: Chairwoman Mary L. Schapiro  
Commissioner Luis A. Aguilar  
Commissioner Kathleen L. Casey  
Commissioner Troy A. Paredes  
Commissioner Elisse B. Walter  
Division of Corporation Finance Director Meredith B. Cross

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## PRIVATE ORDERING AND THE PROXY ACCESS DEBATE

Lucian A. Bebchuk and Scott Hirst

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This paper is also a discussion paper of the  
John M. Olin Center's Program on Corporate Governance

# PRIVATE ORDERING AND THE PROXY ACCESS DEBATE

*By Lucian A. Bebchuk\* and Scott Hirst\*\**

This Article examines two “meta” issues raised by opponents of the SEC’s proposal to provide shareholders with rights to place director candidates on the company’s proxy materials. First, opponents argue that, even assuming proxy access is desirable in many circumstances, the existing no-access default should be retained and the adoption of proxy access arrangements should be left to opting out of this default on a company-by-company basis. This Article, however, identifies strong reasons against retaining no-access as the default. There is substantial empirical evidence indicating that director insulation from removal is associated with lower firm value and worse performance. Furthermore, when opting out from a default arrangement serves shareholder interests, a switch is more likely to occur when it is favored by the board than when disfavored by the board. We analyze the impediments to shareholders’ obtaining opt-outs that they favor but the board does not, and we present evidence indicating that such impediments are substantial. The asymmetry in the reversibility of defaults highlighted in this Article should play an important role in default selection.

Second, opponents of the SEC’s proposed reforms argue that, if the SEC adopts a proxy access regime, shareholders should be free to opt out of this regime. We point out the tensions between advocating such opting out and the past positions of many of the opponents, as well as tensions between opting out and the general approach of the proxy rules. Nonetheless, we support allowing shareholders to opt out of a federal proxy access regime, provided that the opt-out process includes necessary safeguards. Opting out should require majority approval by shareholders in a vote where the benefits to shareholders of proxy access are adequately disclosed, and shareholders should be able to reverse past opt-out decisions by a majority vote at any time.

The implications of our analysis extend beyond proxy access to the choice of default rules for corporate elections, and to the ways in which shareholders should be able to opt out of election defaults. In particular, the current plurality voting default should be replaced with a majority voting default, and existing impediments to the ability of shareholders to opt out of arrangements that make it difficult to replace directors should be re-examined.

Keywords: Proxy access, Securities and Exchange Commission, shareholder voting, corporate elections, corporate governance, directors, default rules, private ordering, boards.

JEL Classifications: G3, G38, K2, K22.

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## I. INTRODUCTION

The ability of shareholders to place director nominees on the company's proxy materials is an issue that the U.S. Securities and Exchange Commission ("SEC") has been considering for over sixty years.<sup>1</sup> In its 2009 proposed rule, Facilitating Shareholder Director Nominations, the SEC has once again revisited this topic.<sup>2</sup> Specifically, the reform proposes a new rule that would become Rule 14a-11 ("Rule 14a-11") of the General Rules and Regulations promulgated under the Securities Exchange Act of 1934.<sup>3</sup> The proposed Rule 14a-11 would, under certain circumstances, require companies to include shareholder nominees for director elections in the companies' proxy materials.<sup>4</sup>

The SEC has received a welter of comments regarding the proposed reform.<sup>5</sup> Although the adoption of a federal proxy access regime has received significant support from shareholder groups and those who work with them,<sup>6</sup> the proposed reform faces strong opposition from the corporate side; comments in opposition have been submitted by many of the country's largest corporations, the Business Roundtable,<sup>7</sup> the U.S. Chamber of Commerce,<sup>8</sup> and other business

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<sup>1</sup> See Amended Proxy Rules, Exchange Act Release No. 34-3347, 7 Fed. Reg. 10653 (Dec. 18, 1942).

<sup>2</sup> Facilitating Shareholder Director Nominations, Exchange Act Release No. 34-60089, 74 Fed. Reg. 29024 (proposed June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249 & 274) [hereinafter Proposed Rule].

<sup>3</sup> See *id.* at 29032.

<sup>4</sup> *Id.* at 29032-33.

<sup>5</sup> 534 comment letters (or memoranda noting meetings with SEC commissioners or staff members) were received through the end of September 2009. All comment letters are available at U.S. Securities and Exchange Commission, Comments on Proposed Rule: Facilitating Shareholder Director Nominations, <http://www.sec.gov/comments/s7-10-09/s71009.shtml> (last visited Dec. 6, 2009).

<sup>6</sup> See, e.g., Letter from Jeff Mahoney, Gen. Counsel, Council of Institutional Investors, to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Aug. 4, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-78.pdf>.

<sup>7</sup> See Letter from Alexander M. Cutler, Chairman & Chief Executive Officer, Eaton Corp., and Chair, Corp. Leadership Initiative, Bus. Roundtable, to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Aug. 17, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-267.pdf> [hereinafter Business Roundtable Letter].

<sup>8</sup> See Letter from David T. Hirschmann, Senior Vice President, U.S. Chamber of Commerce, to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Aug. 14, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-181.pdf> [hereinafter Chamber of Commerce Letter].

organizations, as well as many prominent corporate law firms and bar groups.<sup>9</sup> Many of the commentators opposed to the SEC’s proposal hold the view that proxy access would generally be value-reducing for publicly traded firms. Whether this is the case was the subject of an exchange between Martin Lipton and one of us published by *The Business Lawyer* in 2003, when the SEC previously considered proxy access reform.<sup>10</sup> This time, however, many commentators also stress a set of additional “meta-arguments” against the adoption of a federal proxy regime: they argue that the proposed reform should be opposed even if proxy access is desirable in many or most publicly traded companies<sup>11</sup>. We focus in this Article on these meta-arguments. We will refer to those commentators who make one or both of these meta-arguments collectively as the “Proposal Opponents.” While the views expressed by the Proposal Opponents differ in various respects, this Article will focus on their common use of the meta-arguments to oppose the SEC’s proposal.

Part II of this Article focuses on the argument made forcefully by the Proposal Opponents that, even if proxy access is desirable, it should be adopted in a more limited fashion than proposed by the SEC—by private ordering against the background of a no-access default rule. The Proposal Opponents are willing to support the SEC’s proposal to amend Rule 14a-8 to allow shareholders to place proposals with respect to director nomination procedures on the corporate ballot;<sup>12</sup> once such an amendment is adopted, they argue, the adoption of proxy access can be left to private ordering in the marketplace. Such private ordering, they argue, can be expected to produce a proxy access arrangement in any company in which such access is desirable. Such an

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<sup>9</sup> See, e.g., Letter from Jeffrey W. Rubin, Chair, Comm. on Fed. Regulation of Sec., ABA Bus. Law Section, to Elizabeth Murphy, Sec’y, U.S. Sec. & Exch. Comm’n (Aug. 31, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-456.pdf> [hereinafter ABA Letter].

<sup>10</sup> See Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 48–64 (2003); Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company’s Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003). See also Lucian Arye Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557, 557–68 (2005).

<sup>11</sup> See, e.g., Business Roundtable Letter, *supra* note 7 at 45-46 (“the proposed amendments to Rule 14a-8 would enable shareholders and companies to implement proxy access provisions that are adapted to the distinct characteristics and needs of the individual company”). More generally, in advancing arguments in favor of leaving the adoption of access arrangements to private ordering, Proposal Opponents presuppose that shareholders of some companies will wish to implement proxy access.

<sup>12</sup> See Proposed Rule, *supra* note 4, 74 Fed. Reg. at 29031.

argument for retaining the existing no-access default is made not only by many comments in the SEC file but also by Joseph Grundfest in in a recent discussion paper.<sup>13</sup>

We argue that this objection by the Proposal Opponents should be rejected. The Proposal Opponents are not justified in conflating a preference for private ordering with a preference for the current no-access default. A preference for private ordering may provide a basis for allowing opting out of whatever default is selected, but does not favor any specific default. In particular, assuming that shareholders will be allowed to opt out of the chosen default, we discuss two clear reasons why a no-access default is inferior to, and dominated by, an access default. First, the existing empirical evidence and considerations of director accountability suggest that an access default is more likely to be an efficient arrangement for most public companies. Moreover, efficient opt-outs are much easier to execute when the board of directors favors opting out than when it does not. Our analysis of the impediments facing opt-outs to an access regime from a no-access default indicates that, in many companies where they would be efficient and favored by shareholders, such opt-outs are likely not to occur—or to occur only after a long and costly delay.

Having concluded that the SEC should set access as a default, we focus in Part III on the question of whether opting out of the default to a no-access regime should be permitted, as the Proposal Opponents forcefully advocate. There is a tension between the Proposal Opponents' position in favor of allowing opting out of Rule 14a-11 and (i) the opposition most of the Proposal Opponents expressed in 2007 to facilitating opting out by shareholders from the current no-access default, and (ii) their support—or tacit acceptance—of shareholders' inability to opt out of various arrangements that currently make it more difficult for shareholders to replace directors. The Proposal Opponents overstate the strength of the case for allowing shareholders to opt out of the adopted federal access regime. Indeed, precluding such opting out would be consistent with the long-standing approach of the proxy rules and the securities laws in general.

On balance, however, we support SEC consideration of allowing opting out to no-access, provided that the opting-out process contains adequate safeguards to ensure that proxy access is denied only in those cases where shareholders are and remain in favor of opting out. In

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<sup>13</sup> See Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, Rock Center for Corporate Governance at Stanford University Working Paper No. 64, available at



particular, any opting out of the SEC's access regime should require shareholder majority approval in a vote in which the benefits to shareholders of an access regime are adequately disclosed, and shareholders should be able to reverse past opt-out decisions by a majority vote at any time. Permitting opting out of the SEC's access regime should also lead to a general reconsideration of shareholders' current inability to opt out of arrangements that make it difficult to replace directors.

The analysis presented in this Article has implications beyond the proxy access debate. By analyzing the differences in the ease of passing efficient changes when such changes are supported or opposed by boards, the discussion highlights a consideration that should play an important role in the setting of corporate governance arrangements in general and those governing corporate elections in particular. For example, the analysis suggests that majority voting should become the default arrangement rather than merely a standard from which firms are free to opt out. Similarly, the analysis of how opting out from Rule 14a-11 should be conducted has implications for opting out of other rules governing corporate elections.

## II. SHOULD NO-ACCESS REMAIN THE DEFAULT RULE?

This Part focuses on the Proposal Opponents' argument that, even if proxy access is desirable for the shareholders of many companies, the current no-access default and the adoption of proxy access arrangements should be left to the marketplace—that is, to private adoption by individual companies. A no-access default with the freedom to opt in to an access regime is far from the best response to the proxy access issue. In particular, it is inferior to, and dominated by, a federal access regime with freedom for shareholders to opt out of proxy access. For the purposes of this Part's analysis, we will assume that whatever default rule is chosen—an access regime or a no-access regime—will allow shareholders to opt out of the rule. And we will focus on examining whether the case made by Proposal Opponents that the default rule should be no-access is well grounded. For ease of exposition, we first put forward the case against retaining the no-access default assuming that shareholders' preferences are binary—for either the no-access regime or for the access regime offered by Rule 14a-11; at the end of this Part we introduce the possibility that shareholders prefer some other access regime and show that the

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[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1491670](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1491670), forthcoming in *The Business Lawyer*..

case against a no-access default remains strong when this initial simplifying assumption is relaxed.

Section A of this Part explains why a preference for private ordering should not by itself lead—as the Proposal Opponents seem to believe—to favoring the current no-access default. Sections B and C discuss the two main reasons why an access default should be favored: proxy access is more likely to be efficient for most public companies, and efficient opt-outs are easier to achieve when the board favors them than when the board does not, making it more difficult for shareholders favoring proxy access to opt out of a no-access default than it would be for shareholders favoring no-access to opt out of a federal access regime.

#### *A. The Conflation of Opposition to Proxy Access with Preference for Private Ordering*

A central argument put forward repeatedly by the Proposal Opponents is that, even assuming that access is beneficial for many public companies, the optimal approach is to retain no-access as the default arrangement and let the provision of shareholder access evolve through the adoption of access arrangement on a company-by-company basis.<sup>14</sup> To facilitate such adoption, the Proposal Opponents now endorse a position many of them opposed in 2007: allowing shareholders to place on the corporate ballot proposals with respect to director nominations.<sup>15</sup> The Proposal Opponents stress the virtues of “private ordering,” which can tailor arrangements to companies’ particular circumstances, and seem to believe that a preference for private ordering and “one size does not fit all” cuts strongly against SEC intervention to provide a proxy access regime.<sup>16</sup>

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<sup>14</sup> See note 11, *supra*.

<sup>15</sup> See, e.g., Letter from Cravath, Swaine & Moore LLP et al. to Elizabeth Murphy, Sec’y, U.S. Sec. & Exch. Comm’n 4–5 (Aug. 17, 2009), *available at* <http://www.sec.gov/comments/s7-10-09/s71009-212.pdf> [hereinafter Seven Firm Letter]; ABA Letter, *supra* note 9, at 4.

<sup>16</sup> See, e.g., Seven Firm Letter, *supra* note 13, at 6–7 (recommending that shareholders be permitted “to submit proxy access proposals that are designed to fit a company’s particular circumstances” and that companies would “benefit from the flexibility to adopt the type and form of proxy access standard that best reflects the will of the stockholders, rather than a uniform, one-size-fits-all standard”); Business Roundtable Letter, *supra* note 7, at 45 (suggesting that “permitting shareholders to propose amendments to a company’s bylaws to facilitate proxy access would allow shareholders to take advantage of the opportunity that state law affords to tailor a system of proxy access to the needs of the individual company”).

However, it is a mistake to conflate a preference for private ordering and “one size does not fit all” with a preference for a no-access default, as the Proposal Opponents do. There is no reason to assume as the Proposal Opponents do, that private ordering should begin from a no-access default. A preference for private ordering merely implies a preference for allowing opting out from whichever default is set, and does not imply that the ideal default is no-access. No matter what the default rule, it is possible to have private ordering: if the default rule provides for proxy access, there can be private ordering by allowing corporations to opt out of the regime;<sup>17</sup> if the default rule is no-access, there can be private ordering by allowing shareholders to opt in to proxy access. Therefore, although Proposal Opponents base many of their arguments on a preference for private ordering, such a preference cannot provide a basis for opposition to the provision of an access regime. A preference for private ordering is fully consistent with a proxy access regime as long as opting out is permitted by the regime. The Proposal Opponents’ position is thus grounded *not* in their preference for private ordering but in their preference for a no-access default over an access default.<sup>18</sup>

Grundfest recognizes the need to make an argument in favor of a no-access default, and he claims that, in choosing among alternative defaults, no-access is the only acceptable choice.<sup>19</sup> He argues that the SEC should not adopt an access default without first conducting a scientific survey of shareholders in public companies to confirm that shareholders prefer to have proxy access.<sup>20</sup> This argument implicitly relies on a presumption in favor of a no-access default. We see no reason for such a presumption. Furthermore, and most importantly, the analysis below shows that there is a strong basis for favoring an access default over the current no-access default.

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<sup>17</sup> Note that allowing opting out of the regime—what Joseph Grundfest refers to as “symmetric opt-out”—is different from the current proposed Rule 14a-11, which would only allow shareholders to make the rule less restrictive for shareholder proposals, and not more restrictive (what Grundfest refers to as an “asymmetric opt-out”). See Grundfest, *supra* note 12, at 4.

<sup>18</sup> The fact that Proposal Opponents have a strong preference not just for private ordering over federal intervention but also for having no-access as the default is also evident from the fact that nowhere in their submissions, nor at any time prior to this debate—including during the discussion of the recent amendment of the Delaware General Corporation Law to add section 112 allowing opting in to proxy access—did any of the Proposal Opponents seek to have access as the default arrangement under state law.

<sup>19</sup> See Grundfest, *supra* note 12, at 16.

## *B. The Benefits of Proxy Access*

In choosing between two or more arrangements for a default rule, a natural starting point is to ask which arrangement is more likely to be efficient. If it is as easy to opt out of a no-access default as to opt out of an access default (although we shall see this is not the case), the consideration of which arrangement is more likely to be efficient in most cases should be decisive. Both the logic of corporate accountability and the available empirical evidence indicate that an access default is more likely to be efficient than a no-access default.

Given the central role of directors in corporate governance, their selection and incentives are important: Corporate law provides shareholders with the power to replace boards in order to ensure that directors are adequately selected and perform well.<sup>21</sup> This power should create accountability and incentivize directors to serve shareholders' interests.<sup>22</sup> However, existing arrangements make it difficult for shareholders to replace directors, and give incumbents substantial advantages over outsiders who might seek to replace them in the event of unsatisfactory performance. For example, incumbents' campaign expenses are borne completely by the company, but outsiders have to pay their own campaign costs.<sup>23</sup> Thus, challengers who might be able to improve the management of the company may be discouraged from running because they will bear all of the costs but capture only a fraction of the benefits from any improvement in governance.<sup>24</sup> Electoral challenges are in fact quite infrequent.<sup>25</sup>

Although proxy access would not eliminate the disadvantages facing challengers, it would reduce them somewhat. Challengers would still bear costs that incumbents can charge to the company, but in some circumstances challengers would avoid the costs of distributing proxy

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<sup>20</sup> *See id.* at 23.

<sup>21</sup> *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985) (“If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out.” (citing *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984))).

<sup>22</sup> *See Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (observing that “[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests”).

<sup>23</sup> *See* ROBERT CHARLES CLARK, *CORPORATE LAW* 394–96 (1986).

<sup>24</sup> *See id.* at 390–96; *see also* Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1073, 1088–96 (1990).

<sup>25</sup> For empirical evidence on the incidence of electoral challenges, see Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007) [hereinafter *Bebchuk, Shareholder Franchise*].

cards to shareholders and paying for their return, and would also avoid intangible disadvantages that may result from being on a separate card.<sup>26</sup> By making it easier for shareholders to replace directors, proxy access can contribute to making directors more accountable to shareholders and more attentive to their interests. The primary benefits of proxy access would result not so much from its use, but from its availability and its general effect on directors' incentives and behavior.

There is a substantial body of empirical evidence that is consistent with the view that making boards more accountable by invigorating corporate elections increases shareholder value.<sup>27</sup> Empirical studies consistently find that proxy fights are associated with an increase in shareholder wealth.<sup>28</sup> These studies focus on the *ex post* effects of proxy contests (their effects on shareholder wealth once a proxy contest has taken place), and do not consider the *ex ante* benefits of proxy contests (the effects of the prospect of a proxy contest on boards in general). Even though these studies therefore focus only on a subset of the benefits of electoral challenges, their findings are clearly consistent with the effect of such challenges being positive.<sup>29</sup>

Furthermore, there is considerable empirical evidence that reducing incumbent directors' insulation from removal has, overall, a beneficial *ex ante* effect on the management of public companies. Empirical studies have found that increased insulation from management removal by change of control produces poorer management decisions and performance along a significant number of dimensions. Among other things, there is evidence that:

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<sup>26</sup> See comments of Roy Katzovitz in Lucian Bebchuk & Scott Hirst eds, *The Harvard Law School Proxy Access Roundtable* Harvard John M. Olin Discussion Paper No. 661 (2010), page 55.

<sup>27</sup> For a review of this evidence, see Bebchuk, *supra* note 23, at 711–14.

<sup>28</sup> See Lisa F. Borstadt & Thomas J. Zwirlein, *The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance*, FIN. MGMT., Autumn 1992, at 22; Harry DeAngelo & Linda DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations*, 23 J. FIN. ECON. 29, 30 (1989); Peter Dodd & Jerold B. Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 J. FIN. ECON. 401, 402 (1983); David Ikenberry & Josef Lakonishok, *Corporate Governance Through the Proxy Contest: Evidence and Implications*, 66 J. BUS. 405, 432–33 (1993); J. Harold Mulherin & Annette B. Poulsen, *Proxy Contests and Corporate Change: Implications for Shareholder Wealth*, 47 J. FIN. ECON. 279, 280 (1998).

<sup>29</sup> In its comment letter, the RiskMetrics Group indicates that it has tracked the returns of a portfolio of companies where activists gained board seats in 2005, and found that this portfolio outperformed the S&P 500 index over the subsequent four-year period. See Letter from Martha Carter, Head of Global Research & Global Policy Bd., RiskMetrics Group, to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 3 (Aug. 14, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-166.pdf> [hereinafter

- The passage of anti-takeover statutes is accompanied by increases in “managerial slack”;<sup>30</sup>
- Companies whose managers enjoy more protection from takeovers are associated with poorer operating performance—including lower profit margins, return on equity, and sales growth—and are more likely to engage in empire-building;<sup>31</sup>
- Acquisitions made by companies with stronger anti-takeover protection are more likely to be value-decreasing;<sup>32</sup>
- Anti-takeover protection is associated with higher compensation levels;<sup>33</sup>
- Anti-takeover protection is associated with lower sensitivity of compensation to performance, and with lower sensitivity of CEO turnover to firm performance;<sup>34</sup>
- The removal of anti-takeover protection is associated with increases in stock market value,<sup>35</sup> and
- Greater insulation from removal via a takeover is correlated with lower firm value (as measured by the standard Tobin’s Q measure).<sup>36</sup>

To the best of our knowledge, the only empirical study identifying a beneficial aspect of entrenching management is that by Bates, Becher, and Lemmon.<sup>37</sup> This study found that

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RiskMetrics Group Letter] (concluding that it “appears that election of a shareholder-nominated director may create value over a multi-year period”).

<sup>30</sup> See Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535, 545 (1999) (finding that the adoption of antitakeover statutes weakened managers’ incentives to minimize labor costs); Gerald T. Garvey & Gordon Hanka, *Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage*, 54 J. FIN. 519, 520 (1999) (reporting that antitakeover statutes “allow managers to pursue goals other than maximizing shareholder wealth”).

<sup>31</sup> See Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 136–37 (2003).

<sup>32</sup> Ronald W. Masulis, Cong Wang & Fei Xie, *Corporate Governance and Acquirer Returns*, 62 J. FIN. 1851, 1853 (2007).

<sup>33</sup> See Marianne Bertrand & Sendhil Mullainathan, *Executive Compensation and Incentives: The Impact of Takeover Legislation* at 6 (Nat’l Bureau of Econ. Research, Working Paper No. 6830, 1998) (on file with *The Business Lawyer*).

<sup>34</sup> See Olubunmi Faleye, *Classified Boards, Firm Value, and Managerial Entrenchment*, 83 J. FIN. ECON. 501, 503 (2007).

<sup>35</sup> See Re-Jin Guo, Timothy A. Kruse & Tom Nohel, *Undoing the Powerful Anti-Takeover Force of Staggered Boards*, 14 J. CORP. FIN. 274, 275 (2008).

staggered boards are associated with higher takeover premia.<sup>38</sup> However, this study also shows that staggered boards are associated with a lower likelihood of an acquisition, and, more importantly, it confirms that, overall, staggered boards are associated with lower firm value.<sup>39</sup> On the whole, the body of empirical evidence provides strong reasons for believing that reducing the extent to which directors are insulated from removal would be value-enhancing.

### *C. Default Choice and Reversibility*

Having so far focused on whether no-access or access is more likely to be efficient for most public companies, we now discuss another consideration that weighs heavily against choosing a no-access default: it would be far more difficult for shareholders to opt out of a no-access default when doing so would be efficient, than it would for them to opt out of an access regime when doing so would be efficient.

It is important to take into account the possibility that opting out of different default rules is not equally easy. In an imaginary Coasian world with no transaction costs, permitting opting out would always result in an efficient arrangement, no matter what the initial default. In the real world, however, there are impediments that may prevent efficient opting out, and it is necessary to consider the possibility that these impediments may vary depending on the default that is initially chosen. In particular, as was stressed in an article co-authored by one of us together with Assaf Hamdani, the choice of default in corporate and securities law should depend on which selection would be more easily “reversible” by shareholders wishing to see it changed.<sup>40</sup> Under the reversible defaults theory developed in that article, it is important to take into account the fact that an efficient opting out is easier to accomplish and more likely to occur when a board of

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<sup>36</sup> See Gompers, Ishii & Metrick, *supra* note 30, at 110; Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 430 (2005); Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUDS. 783, 785 (2009).

<sup>37</sup> Thomas W. Bates, David A. Becher & Michael L. Lemmon, *Board Classification and Managerial Entrenchment: Evidence from the Market for Corporate Control*, 87 J. FIN. ECON. 656 (2008).

<sup>38</sup> *Id.* at 658.

<sup>39</sup> *Id.* at 675–76.

<sup>40</sup> See Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults For Corporate Law Evolution*, 96 NW. U. L. REV. 489, 489 (2002).

directors favors such opting out than when the board disfavors it.<sup>41</sup> Below we provide additional support for this view, explaining in detail the causes of this asymmetry as well as demonstrating its significance.

When an efficient opt-out is favored by the board, it will likely be adopted. The board will have an incentive to bring the opt-out proposal to a vote, will have access to internal and external professionals with the necessary skills to draft and explain the proposal expertly, and will have the power to place the proposal and detailed reasons for it in the company's proxy materials. In contrast, the adoption of an opt-out that is efficient and favored by shareholders but disfavored by the board will be much more uncertain due to the various impediments we describe in detail below.

The asymmetry between opt-outs favored and disfavored by the board strengthens the case for selecting proxy access as the default rule. Indeed, the asymmetry provides a basis for selecting access as the default even if no-access is more likely to be the efficient default. Suppose, hypothetically, that proxy access is optimal for 45 percent of companies and no-access is optimal for 55 percent of companies; suppose further that shareholders are able to opt out in all cases in which opting out is favored by the board, but only in one-third of those cases in which opting out is disfavored by the board. In these circumstances, setting an access default would result in the more efficient arrangement prevailing in all companies: all of the 55 percent of companies for which the access default is inefficient and disfavored by shareholders will opt out. In contrast, setting a no-access default would result in 30 percent of companies ending up with an inefficient arrangement: of those 45 percent of companies for which no-access is inefficient, only one-third will opt out.

Grundfest recognizes the need to take these asymmetries into account, arguing that they are reduced in this situation.<sup>42</sup> However, even if this is the case, as long as there is an asymmetry that makes it easier to opt out of proxy access than to opt in, a default rule of proxy access will be preferable. Grundfest concedes that where there are asymmetries in favor of management, the default rule that is less preferred by management should be chosen.<sup>43</sup> However, he claims that, because the adoption of proxy access could be done by a bylaw amendment without director

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<sup>41</sup> *Id.* at 502–03.

<sup>42</sup> *See* Grundfest, *supra* note 12, at 23.

<sup>43</sup> *Id.*



initiation, a different recommendation is appropriate.<sup>44</sup> However, the passage that Grundfest cites for this proposition also states that, where collective action problems impede initiation of bylaw amendments by shareholders (as this section demonstrates), opting out by a bylaw amendment will not eliminate the asymmetry, and, as a result, some presumption in favor of arrangements more restrictive of managers is called for.<sup>45</sup>

#### *D. Impediments to Shareholder Bylaw Amendments and the Precatory Proposals Route*

Why do the Proposal Opponents expect the marketplace to effectively produce access arrangements whenever they are efficient? In assessing this question, it is worth noting that companies have had many years to adopt access bylaws and have not chosen to do so. State corporate law, including in Delaware, contains no restrictions on allowing shareholder access.<sup>46</sup> However, only three companies have put in place a proxy access arrangement, and each of these three instances is peculiar because of either the nature of the company or the circumstances surrounding its adoption of proxy access. One access bylaw was adopted by RiskMetrics Group, Inc., which advocates proxy access reform for the companies in which its clients invest;<sup>47</sup> another was adopted by a company that had as its chairman and significant block holder a well-known shareholder activist who has strongly advocated proxy access;<sup>48</sup> the third access bylaw was adopted by a firm attempting to recover from an option-backdating scandal that led to

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<sup>44</sup>*Id.* (citing Bebchuk & Hamdani, *supra* note 40, at 505).

<sup>45</sup> See Bebchuk & Hamdani, *supra* note 40, at 505.

<sup>46</sup> Although the introduction of section 112 of the Delaware General Corporate Law makes it explicitly clear that bylaws may permit proxy access, *see* 2009 Del. Laws ch. 14, § 1 (Apr. 10, 2009) (H.B. 19) (West) (to be codified at DEL. CODE ANN. tit. 8, § 112), the permissibility of such bylaws was generally recognized prior to the enactment of section 112.

<sup>47</sup> See Section 2.6, Second Amended and Restated By-Laws of RiskMetrics Group, Inc. filed as Exhibit 3.2 to Form S-1/A dated January 8, 2008.

<sup>48</sup> Apria Healthcare, Inc., had Ralph Whitworth, head of investment advisor Relational Investors LLC, as its chairman and significant stakeholder during the period in which it adopted a proxy access bylaw. Mr. Whitworth is a strong advocate of proxy reform, and advocated the change to the board. See Letter from Ralph V. Whitworth, Principal, Relational Investors LLC, to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 1 (Aug. 14, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-185.pdf>. Apria Healthcare, Inc., has subsequently been acquired.

criminal charges against three former executives.<sup>49</sup> It is clear that the implementation of proxy access in those three cases resulted from unique circumstances.

Why should we expect the future to be different from the past? The Proposal Opponents seem to believe that the future will be different if the SEC amends Rule 14a-8 (an amendment they now support) to allow shareholders to place on the corporate ballot proposals concerning director nomination procedures in general, and proxy access in particular. Shareholders' ability to bring such proposals, it is argued, can generally be expected to produce access bylaws in companies in which such bylaws are efficient and favored by shareholders.

It is worth noting that the process the Proposal Opponents have in mind appears to be one in which boards adopt access bylaws following shareholder proposals recommending such bylaws, rather than one in which shareholders adopt such bylaws directly. Although shareholders submit hundreds of proposals to publicly traded firms each year, the overwhelming majority of these proposals are precatory in nature; only a small fraction of shareholder proposals are proposals for binding bylaw amendments. In particular, during the last five proxy seasons, on average only twelve proposals for corporate governance bylaw amendments were voted on each year—about 3 percent of the proposals voted on during the season.<sup>50</sup>

The use of bylaw proposals is impeded by the fact that, in many firms, the amendment of bylaws requires a supermajority: as of September 2009, 42 percent of public companies<sup>51</sup> and 34

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<sup>49</sup> Comverse Technology, Inc., adopted a proxy access bylaw in 2007. See Posting by Ted Allen to RiskMetrics Group Risk and Governance Blog, [http://blog.riskmetrics.com/2007/04/comverse\\_adopts\\_access\\_bylawsu.html](http://blog.riskmetrics.com/2007/04/comverse_adopts_access_bylawsu.html) (Apr. 27, 2007) (“Comverse Adopts Access Bylaw”).

<sup>50</sup> In the last two proxy seasons for which Georgeson Shareholder reports figures, the number of proposals to amend the bylaws was twelve in the 2007 proxy season (out of 375 corporate governance proposals), GEORGESON, 2007 ANNUAL CORPORATE GOVERNANCE REVIEW 20 fig. 12 (2007), available at <http://www.georgesonshareholder.com/usa/acgr09.php>, and seventeen in the 2008 proxy season (out of 339 corporate governance proposals), GEORGESON, 2008 ANNUAL CORPORATE GOVERNANCE REVIEW 22 fig. 12 (2008), available at <http://www.georgesonshareholder.com/usa/acgr09.php>.

<sup>51</sup> This figure is based on a SharkRepellent.net search on September 6, 2009. Out of the 3,889 companies in the SharkRepellent.net universe (comprised of Russell 3000 companies and those companies that have had initial public offerings or implemented poison pills since 2001), a total of 1,624 companies had a supermajority vote requirement for amending the bylaws of the corporation. For subsequent confirmation of this point, see Beth Young, *The Limits of Private Ordering: Restrictions on Shareholders' Ability to Initiate Governance Change and Distortions of the Shareholder Voting Process* 7 (Council of Institutional Investors, Nov. 2009), available at

percent of the Fortune 500 required a supermajority approval for any shareholder-initiated bylaws.<sup>52</sup> Indeed, even among companies that do not have a supermajority requirement, the standard requirement of approval by a majority of the outstanding shares makes passage conditional on obtaining a supermajority of the votes cast.

Furthermore, the initiation of access bylaws by shareholders would be discouraged by the fact that Rule 14a-8 imposes a 500-word limit on the text of the proposed bylaw and the supporting statement.<sup>53</sup> It might well be difficult to fit the text of an access bylaw that explicitly addresses most of the relevant elements (not to mention the supporting statement) within such a limit.<sup>54</sup> For example, the model access bylaw recently put forward by the American Bar

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<http://www.cii.org/UserFiles/file/The%20Limits%20of%20Private%20Ordering%20UPDATED%2011-17-09.pdf> (showing that 36.1 percent of Russell 1000 companies, 39.1 percent of Russell 3000 companies, and 35.4 percent of S&P 500 companies employ a supermajority vote standard). That paper also suggests that another impediment to private ordering will exist for companies with multiple class capital structures with disparate voting rights (7.1 percent of S&P 500 companies, 8.8 percent of Russell 1000 companies, and 7.5 percent of Russell 3000 companies), such that an access bylaw favored by shareholders holding a majority of the shares of the company by value may not receive a majority of total votes. *Id.* at 8.

<sup>52</sup> This figure is based on a SharkRepellent.net search on September 6, 2009. Out of the Fortune 500 companies, 168 companies had a supermajority vote requirement for amending the bylaws of the corporation.

<sup>53</sup> See Proposed Rule, *supra* note 2, 74 Fed. Reg. at 29046.

<sup>54</sup> A shareholder wishing to have an access bylaw might believe, for example, that such a bylaw should ideally deal with, among other things, ownership and shareholding requirements of proponents, disclosure of information, and resolution procedures.

Association Task Force on Shareholder Proposals contains 2,436 words,<sup>55</sup> and the text of Rule 14a-11 itself contains 1,929 words.<sup>56</sup>

The Proposal Opponents have not expressed concerns about these considerable impediments to shareholder-initiated access bylaws. To make their support of opting out against the background of a no-access default tenable, they have to rely on the ability of shareholders to pass precatory shareholder resolutions recommending that the board adopt an access bylaw. Once Rule 14a-8 is amended to allow such precatory proposals, it might be argued, the boards of many companies can be expected to adopt access bylaws after the passage of such proposals or in anticipation of—and with a desire to preempt—the future passage of such proposals.<sup>57</sup> However, as the next subsections demonstrate, this process also cannot generally be relied upon to produce proxy access arrangements whenever shareholders prefer to have them.

#### *E. Lessons from Majority Voting and Staggered Boards*

It is instructive to begin by looking at the evidence on the diffusion of majority voting arrangements, which were often adopted by boards in response to or in anticipation of shareholder resolutions in favor of majority voting. In arguing that private ordering from a no-access default could be relied on to produce proxy access arrangements whenever they would be

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<sup>55</sup> See AM. BAR ASS'N TASK FORCE ON SHAREHOLDER PROPOSALS, ILLUSTRATIVE ACCESS BYLAW WITH COMMENTARY (June 15, 2009), *available at* [http://meetings.abanet.org/webupload/commupload/CL410000/sitesofinterest\\_files/illustrative\\_access\\_bylaw.pdf](http://meetings.abanet.org/webupload/commupload/CL410000/sitesofinterest_files/illustrative_access_bylaw.pdf) [hereinafter ABA MODEL BYLAW]. To take another example, the model bylaw circulated by Wachtell, Lipton, Rosen & Katz contains 1,401 words. See WACHTELL, LIPTON, ROSEN & KATZ, MODEL PROXY ACCESS BOARD RESOLUTION AND BY-LAW (May 7, 2009), *available at* <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.16648.09.pdf> [hereinafter Wachtell, LIPTON, ROSEN & KATZ MODEL BYLAW]. This model bylaw is discussed in Posting by Theodore Mirvis to Harvard Law School Forum on Corporate Governance and Financial Regulation, <http://blogs.law.harvard.edu/corpgov/2009/05/24/secs-proxy-access-proposal-undermines-state-federal-balance/> (May 24, 2009, 7:24 EST) (“SEC’s Proxy Access Proposal Undermines State-Federal Balance”). Word counts were calculated in Microsoft Word after cutting and pasting the text of the bylaws (including section numbering, but excluding footnotes and explanatory text).

<sup>56</sup> See Proposed Rules, *supra* note 4, 74 Fed. Reg. at 29082–85. The number of words was calculated in Microsoft Word after cutting and pasting the text of Rule 14a-11 from the original PDF files version. The word count includes section numbering and section headings but excludes titles, footnotes, explanatory text, and instructions.

efficient, the Proposal Opponents argue that the widespread adoption of majority voting from the plurality voting default via private ordering demonstrates that private ordering can produce desirable election reforms.<sup>58</sup> The Business Roundtable Letter, for example, refers to the “swift adoption” of the majority voting standard, and states that some form of majority voting had been adopted by 75 percent of the Roundtable’s members by 2008.<sup>59</sup>

In fact, however, the empirical evidence on the diffusion of majority voting highlights the limits of relying on private ordering by firms, rather than on a change in default arrangements, to produce necessary reforms. Consider a hypothetical situation in which majority voting is the default arrangement from which firms can opt out only with shareholder approval. Given the strong support for majority voting among investors,<sup>60</sup> it is likely that the overwhelming majority of companies would not be able (and indeed would not try) to get shareholders to approve opting out of majority voting into plurality voting, and that most public firms would have majority voting in place. This is a very different outcome than that produced by firms opting out of the current default of plurality voting.

In fact, several years after the widespread recognition of the desirability of a majority voting standard, a large fraction of public firms, including a large majority of smaller public firms, have not yet opted into majority voting. As of September 2009, data from RiskMetrics Group shows that only 60 percent of companies in the S&P 500 had majority voting (with an additional 15 percent having plurality voting with a director resignation policy), and that only a small minority of the large number of public companies outside the S&P 500 have majority voting.<sup>61</sup> Of the 5,930 firms outside the S&P 500 that are followed by RiskMetrics Group, only 12 percent have majority voting (an additional 5 percent had plurality voting with a director resignation policy).<sup>62</sup> Altogether, of the 6,630 public firms in the RiskMetrics database, more

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<sup>57</sup> See, e.g., Seven Firm Letter, *supra* note 13, at 1; ABA Letter, *supra* note 9, at 4; Business Roundtable Letter, *supra* note 7, at 3.

<sup>58</sup> See, e.g., ABA Letter, *supra* note 9, at 7–8, 12; Seven Firm Letter, *supra* note 13, at 3, 6.

<sup>59</sup> See Business Roundtable Letter, *supra* note 7, at 6–7.

<sup>60</sup> Of the 220 proposals to change plurality voting to majority voting that have been voted on since 2007 (as reported by SharkRepellent.net on September 6, 2009), the number of shareholders in favor of the resolution was 59 percent of the shares outstanding, and 70 percent of the votes cast in favor or against.

<sup>61</sup> E-mails from Carol Bowie, RiskMetrics Group, Inc., to Lucian Bebchuk (Oct. 9, 2009) (on file with *The Business Lawyer*).

<sup>62</sup> *Id.*

than 80 percent have plurality voting without even a resignation policy for directors receiving a majority of withhold votes.<sup>63</sup>

The above evidence indicates that, as long as the default arrangement remains the same, many public firms can be expected to avoid opting out into arrangements that make director removal easier—even when there is strong support for such arrangements among shareholders. We discuss below in detail the reasons why private ordering cannot be relied upon to produce such governance improvements. The lessons from the incomplete diffusion of majority voting are worth keeping in mind while considering that analysis.

Indeed, if the adoption of proxy access arrangements is left up to firms opting in to such arrangements, shareholders' ability to implement the access arrangements they favor is likely to face even greater obstacles than those faced by majority voting. Most importantly, boards have generally displayed much more resistance to proxy access than to majority voting. In the beginning of this decade, both proxy access and majority voting were considered important measures for addressing growing concerns about corporate governance in general and corporate elections in particular.<sup>64</sup> Both at the time and since, companies have been open to considering and adopting majority voting, but have been strongly opposed to proxy access.<sup>65</sup> What might be the reasons for the difference in corporate attitudes? Perhaps incumbent directors and executives find majority voting less threatening because it does not create risks that outsiders not screened and selected by the incumbent team will join the board, or perhaps reasonable and persuasive objections to majority voting are difficult to identify. Whatever the reason, incumbent directors' resistance to proxy access arrangements should be taken into account in any assessment of the expected incidence of the adoption of such arrangements from a no-access default.

Furthermore, in contrast to majority voting arrangements, the design of proxy arrangements seems to be more complicated and their consequences seem to depend on many

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<sup>63</sup> *Id.*

<sup>64</sup> *See* Security Holder Director Nominations, Exchange Act Release No. 34-38626, 68 Fed. Reg. 60784, 60794 (proposed Oct. 14, 2003).

<sup>65</sup> *See, e.g.*, Letter from Steve Odland, Chairman, President & CEO, AutoZone, Inc. & Chairman, Corp. Governance Task Force, Bus. Roundtable, to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n 1 (Mar. 31, 2004), *available at* <http://www.sec.gov/rules/proposed/s71903/brt033104.pdf> ("The proposed rules would have widespread and harmful unintended consequences, enabling a small number of

more design details.<sup>66</sup> As a result, as discussed in detail below,<sup>67</sup> firms have many ways to design proxy access arrangements that in practice make their use by shareholders very difficult. This consideration is especially important given the expected reluctance of boards to adopt proxy access arrangements that could make a practical difference.

The evidence of staggered boards is also instructive in assessing how difficult it is for shareholder preferences, expressed in precatory shareholder proposals, to produce widespread changes that would make it easier to replace directors. For the last two decades, companies have generally not been able to get shareholders to approve the adoption of staggered boards.<sup>68</sup> Moreover, shareholders have displayed strong preferences for the removal of staggered boards where companies already have them in place. Proposals in favor of de-staggering have obtained, on average, more than 70 percent of the votes cast for such proposals in each of the years 2003 to 2009, with the average percentage of support in 2007 and 2008 reaching levels of 86 percent and 80 percent respectively.<sup>69</sup> This opposition by shareholders has led to de-staggering by a significant number of companies, though most of the companies with staggered boards have stuck to an arrangement that does not have majority support among shareholders. Among the (approximately) 4,000 public firms whose antitakeover arrangements are tracked by SharkRepellent.net, about half still have staggered boards in place.<sup>70</sup> This evidence suggests that strong impediments exist to shareholder efforts to make corporate governance changes that would facilitate replacing directors. We now turn to a discussion of these impediments in some detail.

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shareholders and advisory services to impose significant costs on all shareholders, often for reasons wholly unrelated to sound corporate governance or the welfare of the corporation.”).

<sup>66</sup> See *supra* notes 55–56 and accompanying text.

<sup>67</sup> See *infra* notes 82–87 and accompanying text.

<sup>68</sup> See, e.g., Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PENN. L. REV. 713, 727–8 (2003); Michael Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755, 759–61 (2003).

<sup>69</sup> These figures are based on a SharkRepellent.net search on October 19, 2009.

<sup>70</sup> This figure is based on a SharkRepellent.net search on September 27, 2009, showing 1,911 corporations in the SharkRepellent.net universe with a staggered board and 1,977 without a staggered board.

## *F. Impediments to the Effectiveness of the Precatory Proposals Route*

The Proposal Opponents claim that a no-access default regime with freedom to opt in to proxy access will produce access arrangements whenever they are favored by shareholders. The evidence discussed above casts doubt on this claim. This subsection discusses three reasons for expecting that a no-access default that allows shareholders to include proposals concerning proxy access on the corporate ballot will not result in the adoption of such arrangements in all firms whose shareholders would benefit from them.

First, due to the limited incentives shareholders have to make proposals, most companies will not receive, and will not expect to receive, shareholder proposals to adopt a proxy access arrangement, even when such proposals would pass were they initiated. Second, even if proxy access proposals are passed (or are expected to pass), boards may elect not to follow shareholders' explicit preference in favor of proxy access. Third, even in those cases where boards adopt a proxy access bylaw—either in response to or in anticipation of the passage of a shareholder proposal—the board may adopt a version of an access arrangement that is substantially more diluted and restrictive than shareholders favor.

### *1. The Limited Reach of Precatory Proposals*

The Proposal Opponents implicitly assume that companies whose shareholders would pass a proxy access proposal, were one to be initiated, would receive or expect to receive such a proposal. But the fact that a proposal would be passed if initiated hardly implies that a proposal will be initiated. Most shareholders have little incentive to initiate such proposals, and the evidence clearly indicates that shareholder proposals that routinely receive large shareholder support are initiated in only a small subset of relevant companies. Although it takes only one shareholder to initiate a proposal, most firms do not receive even a single shareholder proposal.

In particular, according to an analysis of RiskMetrics Group data, less than 25 percent of the firms in the S&P 1500 were targeted for corporate governance proposals in each of the years 2006 and 2007.<sup>71</sup> The RiskMetrics shareholder data focuses on S&P 1500 companies because

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<sup>71</sup> E-mails from Fabrizio Ferri, N.Y. Univ. Leonard N. Stern Sch. of Bus., to Lucian Bebchuk (Oct. 14, 2009) (on file with *The Business Lawyer*).



shareholder corporate governance proposals are infrequent in other companies.<sup>72</sup> According to this data, about 50 percent of the S&P 500 firms received such proposals (243 in 2006 and 265 in 2007).<sup>73</sup> Among those S&P 1500 firms not in the S&P 500, only about 10 to 12 percent received corporate governance proposals (101 in 2006 and 121 in 2007).<sup>74</sup> Note also that, even though proposals to de-stagger boards and to adopt majority voting routinely pass when initiated in companies with a staggered board and plurality voting (respectively), such proposals are initiated only in a small subset of such firms each year. Thus, there is a good basis for expecting that, in a no-access default regime, many companies—including most companies outside the S&P 500—will not expect to be the target of a proxy access proposal, even if such a proposal would pass were it to be initiated, and thus the boards of those companies will face little pressure to adopt an access arrangement.<sup>75</sup>

## 2. *Precatory Proposals May Be Ignored*

As discussed in section D of this Part, the process that the Proposal Opponents envisage is that shareholders will propose precatory resolutions to implement proxy access. However, when a precatory resolution in favor of proxy access passes, the board may elect not to follow it. As a legal matter, the passage of a precatory resolution does not bind the board—the board is

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<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> See Grundfest, *supra* note 12, at 26 (asserting that “collective action costs [for shareholder proposals] are low” and referring to what he regards as a large number of shareholder proposals). However, placed in the context of the number of publicly traded companies and the number of different corporate governance proposals facing shareholders, the number of corporate governance proposals initiated each year is hardly large. Indeed, the great majority of publicly traded companies do not receive even a single proposal in any given year. The 1,141 proposals Grundfest describes represent an average of 0.12 proposals per publicly traded company, or one proposal for every eight publicly traded companies (using the 8,949 publicly traded U.S. companies in the Compustat database as of December 31, 2008). Moreover, the number of proposals Grundfest refers to includes corporate social responsibility proposals; the number of corporate governance proposals is considerably lower (S&P 1500 companies received 652 corporate governance proposals in 2008). See GEORGESON, 2008 ANNUAL CORPORATE GOVERNANCE REVIEW, *supra* note 50, at 14 fig. 1. And in any given year, even the most popular corporate governance issues attract very few proposals—in 2008 there were eighty proposals regarding majority voting and sixty regarding “say-on-pay,” the two most popular issues for shareholder proposals that year. See *id.* at 5, 6.

legally free to elect to retain the existing state of affairs.<sup>76</sup> As a practical matter, the chance that a board will fail to follow a successful precatory resolution is likely to be greater if the resolution is the first proposal on the subject passed by the company's shareholders, if the issue is especially important to incumbents,<sup>77</sup> and if the resolution passes without a large majority.

This analysis is consistent with the evidence of boards' failure to follow numerous precatory resolutions passed in favor of de-staggering boards. A study by one of us shows that, of the precatory resolutions passed by shareholders during the period 1997–2003, boards elected not to follow about 69 percent of such resolutions by the fall of 2004.<sup>78</sup> Recent evidence suggests that the incidence of boards failing to implement de-staggering proposals is now lower—possibly as a result of the consistently large support for such resolutions recently—although a significant number of firms still continue to have staggered boards despite the passage of one or more shareholder resolutions in favor of de-staggering.<sup>79</sup> Thus, even in the event that shareholders pass resolutions in favor of proxy access in some companies, some boards can be expected to ignore such resolutions, and the incidence of such refusals is likely to be higher during the initial years in which proxy access resolutions are passed and when such resolutions pass with less than overwhelming majorities.

### *3. Precatory Proposals May Be Only Partly Followed*

There is another reason why the process suggested by the Proposal Opponents cannot be expected to result in the proxy arrangements favored by shareholders of particular companies

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<sup>76</sup> Cf. *Spiegel v. Buntrock*, 571 A.2d 767, 775-76 (Del. 1990). See also the discussion in Andrew R. Brownstein & Igor Kirman, *Can A Board Say No When Shareholders Say Yes? Responding To Majority Vote Resolutions*, 60 BUS. LAW. 23, 39-45 (2004).

<sup>77</sup> See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 852–56 (2005).

<sup>78</sup> *Id.* at 854.

<sup>79</sup> Comprehensive Summary of Majority Voting Proposals, 2008, SharkRepellent.net (last visited Dec. 10, 2009). For instance, between 2001 and 2008, there were fifty-two corporations in which shareholders successfully passed at least one precatory resolution recommending the repeal of their particular corporation's staggered board, but, as of September 2009, the respective boards of directors had not taken steps to declassify the boards. In eighteen of these instances, shareholders have passed such resolutions on more than one occasion. For instance, the shareholders of The Stanley Works have passed resolutions calling for the removal of a staggered board in each of the seven annual meetings from 2003 to 2009, yet there has been no repeal of the staggered board.

being universally adopted by those companies. Even if the board elects to adopt an access bylaw in response to (or in anticipation of) the passage of a precatory shareholder resolution favoring proxy access, the board may choose to adopt a bylaw considerably more restrictive than the arrangement favored by shareholders. By adopting an access bylaw, the board can claim to accommodate its shareholders' preference. However, the devil is in the details, and the bylaw adopted by the board may fall significantly short of that favored by shareholders.<sup>80</sup>

In response to (or in anticipation of) shareholder resolutions in favor of a majority voting standard, for example, some boards have nonetheless retained the default plurality standard but have sought to placate shareholders by adopting a "director resignation policy."<sup>81</sup> Such policies require directors receiving a majority of "withhold" votes to tender their resignations, but fall short of a majority voting standard, as they are binding neither on directors (to tender their resignations), nor on the board (to accept tendered resignations). During the 2009 proxy season, directors of Pulte Homes, Inc., and Dollar Tree, Inc., failed to receive a majority of votes cast, yet even though both companies had director resignation policies that were triggered by the votes, their boards decided not to accept the resignations of the directors.<sup>82</sup> As noted above, RiskMetrics Group data indicates that 15 percent of companies in the S&P 500 (and 5 percent of all companies followed by RiskMetrics Group) have director resignation policies but not majority voting rules.<sup>83</sup>

This problem is especially significant for proxy access bylaws. As discussed above, the design of a proxy access arrangement can critically affect its effectiveness in providing shareholders with meaningful access to the company's proxy materials. It is possible to draft

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<sup>80</sup> This impediment is largely avoided if shareholders adopt a binding access bylaw. However, as discussed earlier, the passage of binding bylaws by shareholders faces considerable impediments, and this is not the process that the Proposal Opponents envisage. *See supra* note 50 and accompanying text.

<sup>81</sup> For example, in May 2008, shareholders of Invacare Corporation passed a precatory resolution recommending adoption of a majority voting policy. Instead, the board of directors adopted a director resignation policy. *See* Comprehensive Summary of Majority Voting Proposals, 2008, SharkRepellent.net (last visited Dec. 10, 2009).

<sup>82</sup> *See* Posting by Ted Allen to RiskMetrics Group Risk & Governance Blog, <http://blog.riskmetrics.com/2009/10/001372print.html> (Oct. 2, 2009) ("A Closer Look at High Withhold Votes").

<sup>83</sup> *See* E-mails from Carol Bowie, *supra* note 61.

proxy access arrangements with thresholds and requirements that largely negate their potential value for shareholders.

To illustrate, consider a company whose board passes a bylaw based on the model access bylaw put forward by Wachtell, Lipton, Rosen & Katz.<sup>84</sup> An examination of the fine details of the model bylaw indicates that it provides access in name only. First, it requires a nominator to have more than 5 percent of the voting shares of the corporation (a “5% shareholder”) and does not allow shareholder groups to aggregate their holdings for this purpose.<sup>85</sup> As a result, if the company lacks 5 percent shareholders, or if the 5 percent shareholders are affiliated with management, there will effectively be no shareholder access to the ballot. Second, although the model bylaw theoretically allows shareholders to place on the ballot nominees numbering up to one-third of the number of board seats,<sup>86</sup> each 5 percent shareholder may nominate only one director.<sup>87</sup> Therefore, to have three shareholder nominees included on the ballot of a company with nine directors, the company must have at least three 5 percent shareholders, each of which must elect to exercise its proxy access rights. Finally, the model bylaw also deters the use of proxy access rights by 5 percent shareholders by making such use quite costly: shareholders exercising their right to nominate a director are precluded from nominating directors or soliciting proxies in the following year<sup>88</sup> and are subject to substantial limitations on their ability to sell shares, imposing a significant loss of liquidity.<sup>89</sup> The adoption of a bylaw with such tight restrictions should hardly be viewed as providing shareholders with meaningful proxy access.

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<sup>84</sup> See WACHTELL, LIPTON, ROSEN & KATZ MODEL BYLAW, *supra* note 55. This model bylaw imposes significantly more restrictive conditions on proxy access than the ABA Model Bylaw, *supra* note 55, which is in turn significantly more restrictive than proposed Rule 14a-11. Although the access restrictions in bylaws adopted by boards pursuant to the process that the Proposal Opponents envisage will vary, that process will allow boards to adopt bylaws that are more restrictive than what shareholders would prefer.

<sup>85</sup> WACHTELL, LIPTON, ROSEN & KATZ MODEL BYLAW, *supra* note 55, § (b)(v) (defining “Required Interest”).

<sup>86</sup> See *id.* § (b)(i) (defining “Permitted Number,” with provisos, as “one-third of the number of seats on the Board of Directors to be filled in the Election (rounded down to the nearest whole number but not less than one).”)

<sup>87</sup> *Id.* § (c) (“[E]ach Eligible Stockholder, together with its Affiliates, may nominate one, and not more than one, individual under this Section for inclusion in the Corporation’s proxy statement and on its proxy card.”).

<sup>88</sup> *Id.* § (d)(vi).

<sup>89</sup> See *id.* § (d)(1) (requiring an affidavit delivered by the nominating shareholder to represent that the nominating shareholder will “not sell or otherwise dispose of its Beneficial Ownership and Economic

### *G. Different Access Regimes*

We have so far assumed for the purposes of this Part that shareholders' preferences are binary, for either the access arrangement specified by a federal access regime or no-access. The Proposal Opponents stress that "one size does not fit all" and that companies vary considerably in their characteristics and circumstances. We now consider the possibility that optimal access regimes, and those preferred by shareholders, may differ among companies. We conclude that, also under this assumption, an access default would be preferable to retaining a no-access default.

We continue to assume that shareholders will be free to opt out of whichever default rule is chosen. In Part III we discuss in detail the manner in which shareholders should be permitted to opt out of a federal access regime. Under the SEC's proposal, firms would be able to adopt bylaws that provide more expansive access rights than provided by the federal access regime. As will be explained in more detail in Part III, we also support allowing shareholders to adopt resolutions opting out of the federal access regime. Thus, a firm would be able to substitute an access regime with more restrictive access rights than provided in the federal access regime by (i) passing a shareholder resolution to opt out of the federal access regime, and (ii) as the company would no longer be governed by the federal access regime, adopting a bylaw providing the desired set of access rights.

Consider a set of companies whose shareholders prefer access regimes (which might vary from company to company) that provide access rights that are more restrictive than those provided by the federal access regime. Each of these access regimes may be viewed as being located on a spectrum between no-access and the federal access regime. In the view of the Proposal Opponents, a no-access default should be the baseline from which shareholders of any given company in the set opt out to the access arrangement that they prefer. However, setting the

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Interest of voting securities of the Corporation so as to reduce the Beneficial Ownership and Economic Interest held by such [nominating shareholder], together with its Affiliates, below the [5 percent] Required Interest on or prior to the date of the Election (and representing that they have no present intention of reducing, within one year following the Election, their aggregate Beneficial Ownership and Economic Interest below the greater of (x) the [5 percent] Required Interest and (y) seventy-five percent (75%) of their aggregate Beneficial and Economic Interest as of the Advance Notice Date)").

federal access regime as a default would be more likely to result in a given company becoming subject to the access arrangement preferred by its shareholders.

The reason for this is the asymmetry discussed above between opting out in a direction favored by incumbent directors and opting out in a direction disfavored by incumbent directors. Because of this asymmetry, if a no-access default is retained, many firms whose shareholders prefer an access arrangement would likely remain without such an arrangement. In contrast, if a federal access regime is set as a default, and the shareholders of a company prefer an access regime that provides more restrictive access rights, a change to the shareholders' preferred regime would be more likely. Such a change would be likely to take place since it would be favored not only by the shareholders but also by the directors, and the board could therefore be expected to ensure that shareholders have the chance to vote on a resolution to opt out of the federal access regime and adopt a bylaw providing the desired access arrangement (or the board could pass such a bylaw themselves). We conclude that the case for a no-access default is not strengthened by recognizing that "one size does not fit all" and that the optimal access regime that shareholders prefer varies among companies. Instead, the impediments to opting out in a direction disfavored by directors make a no-access default an inferior starting point for moves to optimal access arrangements.

More generally, assuming a federal access regime is provided as a default, and that shareholders are permitted to opt out to both more and less restrictive access rules, the above analysis indicates that changes to access rules preferred by shareholders of particular companies are less likely to occur where shareholders prefer more expansive access rights than provided by the federal regime, than where shareholders prefer less expansive access than provided by the federal regime. This conclusion provides an important insight concerning the setting of the various dimensions of the federal access regime, such as eligibility thresholds and procedural requirements for nominating directors. The SEC should not design the default access regime in accordance with what it believes to be optimal for the "average" publicly traded company. Because it would be more difficult for shareholders seeking changes to expand access rights than to restrict them, the optimal default rule will be one that provides more expansive access rights than are likely to be optimal for the "average" company.

Thus, although a discussion of the design of the various detailed dimensions of the federal access regime is beyond the scope of this Article, our analysis of private ordering and the

proxy access debate suggests an important consideration for such an analysis. The design of the federal access regime should err on the side of providing meaningful access rights. This would result in more companies becoming subject to the exact access arrangements preferred by their shareholders.

#### *H. An Access Regime Should Be the Default*

The above analysis and empirical evidence clearly demonstrates the limitations of the process on which Proposal Opponents wish to rely as a substitute for a federal access regime. Retaining a no-access default and leaving the adoption of proxy access arrangements to company-by-company adoption cannot be expected to result in the general adoption of proxy access arrangements by all of the public companies whose shareholders would favor such an arrangement. Among the thousands of public companies, many—possibly most—will avoid adopting a proxy access arrangement, at least for several years, and a number of those companies adopting proxy access arrangements will implement details that are significantly more restrictive than those favored by their shareholders.

It should be stressed that the outcome for public companies as a whole is likely to be even worse than the percentage of companies failing to adopt proxy access arrangements favored by their shareholders would suggest. That is, the companies that will avoid adopting proxy access arrangements are likely to be among those whose directors are already less accountable to shareholders and less attentive to shareholder interests—in other words, the companies for which effective proxy access is especially important.

#### *I. Beyond Proxy Access*

Although we have so far focused on proxy access, the analysis in Part II has implications that go beyond proxy access—in particular, for the choice of default arrangements with respect to other election arrangements. As detailed above, the empirical evidence suggests that subjecting directors to enhanced risk of removal in the event of underperformance can be expected to increase shareholder value. Given the centrality of election arrangements to the corporate structure, public officials would do well to reconsider whether existing arrangements that insulate directors from removal are warranted.

We have also analyzed the impediments to shareholders forcing companies to opt in to arrangements favored by shareholders but disfavored by boards, and have discussed evidence showing how these impediments substantially limit the speed and efficacy of adopting such arrangements. Our analysis lends support to the “reversible defaults” analysis put forward earlier by one of us together with Assaf Hamdani.<sup>90</sup> In selecting default arrangements, public officials should take into account the fact that a switch from an inefficient default to a more efficient arrangement that would be favored by shareholders is more likely to occur when such a switch is favored by the board than when it is disfavored. This consideration should be given significant weight when defaults are initially selected, and also whenever they are re-examined.

In addition to changing the default rule that currently denies shareholder director nominees access to the corporate ballot, other defaults should be re-examined with the above considerations in mind. For example, we believe there is a strong basis for replacing the current default of plurality voting with a majority voting default. Although there is now widespread recognition that majority voting should be the standard for director elections, we have shown that its diffusion has been much more limited than is commonly supposed: as noted above, a substantial number of S&P 500 companies, and a large majority of the thousands of public companies outside the S&P 500, remain subject to plurality voting. This is due to the difficulties of getting public companies, and especially smaller companies that are not usually the target of shareholder proposals, to adopt arrangements favored by shareholders but not by boards of directors.

Accordingly, it is not sufficient to allow companies to opt in to majority voting. As long as plurality voting remains the default, many if not most public companies will be governed that way, even if their shareholders prefer majority voting and would not support plurality voting if asked to vote on the matter. Switching to a majority voting default, which will contribute to improving corporate elections, is therefore warranted.

### III. SHOULD SHAREHOLDERS BE ALLOWED TO OPT OUT OF THE FEDERAL ACCESS REGIME?

Part II of this Article concluded that there is a strong case for replacing the current no-access default with a proxy access default. Because state law has failed to provide proxy access

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<sup>90</sup> See Bebchuk & Hamdani, *supra* note 40.



arrangements, federal law should provide a proxy access default rule. We now consider whether and to what extent opting out of a federal access regime should be permitted.

The Proposal Opponents argue forcefully in favor of allowing opting out; this is the position taken by the Business Roundtable Letter,<sup>91</sup> the Seven Firms Letter,<sup>92</sup> and by the letters of numerous law firms<sup>93</sup> and corporations.<sup>94</sup> Indeed, Grundfest goes so far as to claim that an SEC rule that did not allow opting out would be irrational, to such a degree that it would fail the rationality test of the Administrative Procedure Act.<sup>95</sup>

Section A begins by pointing out the inconsistencies between the Proposal Opponents' strong support for the ability to opt out of a proxy access regime and (i) their prior positions against the ability to opt out of the current no-access regime when the SEC considered allowing such opting out in 2007, and (ii) their acceptance of mandatory arrangements making it difficult for shareholders to replace directors, from which shareholders are not permitted to opt out. We also note that the Proposal Opponents overstate the strength of the case for allowing opting out,

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<sup>91</sup> See Business Roundtable Letter, *supra* note 7, at 47 (“[W]e believe that shareholders should be permitted to propose amendments to a company’s bylaws that would increase or decrease the requirements of the [Proposed Rules].”).

<sup>92</sup> See Seven Firm Letter, *supra* note 13, at 1–2 (“any prescriptive proxy access regime should permit private ordering under state law so as to permit stockholders to modify the SEC’s proxy access regime as they see fit, including by opting out of the SEC’s proxy access regime in its entirety”).

<sup>93</sup> See, e.g., Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth Murphy, Sec’y, U.S. Sec. & Exch. Comm’n 10 (Aug. 17, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-263.pdf> [hereinafter Wachtell, Lipton, Rosen & Katz Letter] (“If the SEC enacts a federal shareholder access rule, we urge that it adopt a default rule that each company may supplement, replace or repeal as befits its individual circumstances.”); *id.* at 11 (“no access rule [the SEC] adopts should prevent shareholders and the companies in which they have invested from opting out of, or otherwise modifying, one or more aspects of that rule”). See also Letter from Sullivan & Cromwell LLP to Elizabeth Murphy, Sec’y, U.S. Sec. & Exch. Comm’n 4 (Aug. 17, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-430.pdf> (“if Rule 14a-11 is adopted, it should be . . . a default rule that permits companies to opt out with shareholder approval”).

<sup>94</sup> See, e.g., Letter from Mary T. Afflerbach, Air Prods. & Chems., Inc., et al., to Elizabeth Murphy, Sec’y, U.S. Sec. & Exch. Comm’n 4 (Aug. 17, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-472.pdf> (“companies, boards and shareholders should be allowed to determine the proxy access regime at their companies”).

<sup>95</sup> See Grundfest, *supra* note 12, at 29, where he suggests that it is irrational to accept that shareholders have the capacity to nominate and elect directors, and simultaneously to view them as not capable of making good choices about whether to opt out of an access regime; he contends that this contradiction, and a second contradiction that he describes, “are likely fatal to the Proposed Rules under the Administrative Procedure Act.”

and that preventing opting out in a way that would dilute the protections accorded to shareholders by the proxy access regime is consistent with the general structure of the proxy rules. In Section B we turn to our own position on the subject. Although prohibiting opting out that would weaken shareholder rights would not be unreasonable, we support allowing opting out of the proxy access regime in both directions—provided, however, that such opting out is done by a process that contains certain important elements and conditions. We also argue that allowing opting out of proxy access should be accompanied by a reconsideration of existing rules that prevent shareholders from opting out of arrangements that make replacing directors more difficult.

#### *A. Some Questions About the Proposal Opponents' Position on Opting Out*

The Proposal Opponents present a forceful defense of shareholders' right to opt out of proxy access rules.<sup>96</sup> The Seven Firm Letter, for example, stresses that depriving shareholders of their right to opt out of the access regime would be “wrong as a matter of policy.”<sup>97</sup> This recognition of the value of shareholder choice expressed by corporations and corporate law firms is welcome and encouraging. However, it is interesting to observe that many of the Proposal Opponents seem more inclined to allow opting out of arrangements making it easier to replace directors than opting out of arrangements making it difficult to replace directors. Their underlying position seems to be guided not by the view that permitting opting out is desirable, but rather by the view that director removal should be difficult.

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<sup>96</sup> See, e.g., Wachtell, Lipton, Rosen & Katz Letter, *supra* note 92, at 10 (“If the SEC enacts a federal shareholder access rule, we urge that it adopt a default rule that each company may supplement, replace or repeal as befits its individual circumstances.”); Business Roundtable Letter, *supra* note 7, at 47–48 (“We believe that there is no legitimate reason to allow shareholder proposals that would impose more lenient but not more restrictive access requirements on nominating shareholders. Rather, the Commission should let companies and their shareholders decide whether or not, and to what degree, they wish to permit shareholders to include their director nominees in company proxy materials.”).

<sup>97</sup> Seven Firm Letter, *supra* note 13, at 3 (“If the SEC adopts proposed Rule 14a-11, stockholders should have the option to opt out of proposed Rule 14a-11 either by a stockholder vote or ratification of board action. . . . [P]roposed Rule 14a-11 would deprive stockholders of their ability to exercise their rights under enabling state laws to implement the specific form of proxy access that they believe best fits their particular company and fellow stockholders, or alternatively to choose to forego entirely the costs and burdens of proxy access. We think this result is wrong as a matter of policy and raises significant administrative law issues.”).

Two inconsistencies in particular are worth discussing. First, the Proposal Opponents' current position in favor of allowing opting out conflicts with the position many of them expressed in 2007 when the SEC considered allowing shareholders satisfying certain eligibility standards to include on the corporate ballot proposals to opt out of the current no-access default (the "2007 Shareholder Proposal Rule").<sup>98</sup> Although the Proposal Opponents now argue strongly that shareholders should be allowed to opt out of *any* access regime, in 2007 many of them—including the Business Roundtable, the U.S. Chamber of Commerce, and a number of prominent corporate law firms—strongly opposed allowing shareholders to include proposals to opt out of the current no-access rule on the corporate ballot.<sup>99</sup> For example, the U.S. Chamber of Commerce, in a comment letter regarding the 2007 Shareholder Proposal Rule, indicated that it "strongly oppose[d] the [2007 Shareholder Proposal Rule] as unnecessary, overreaching and potentially disruptive and harmful to companies and shareholders."<sup>100</sup> At the time, the strong opposition to allowing shareholders to opt out of the current no-access default prevailed, and the SEC adopted the current rule allowing companies to exclude opt-out proposals.<sup>101</sup>

Comparing the positions of many Proposal Opponents in 2007 with their positions today, it seems that the fundamental principle underlying their current position is not that of permitting shareholders to opt out and choose the arrangements they find most fitting. Rather, the position

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<sup>98</sup> Shareholder Proposals, Exchange Act Release No. 34-56160, 72 Fed. Reg. 43466 (proposed July 27, 2007) (to be codified at 17 C.F.R. pt. 240) [hereinafter 2007 Shareholder Proposal Rule].

<sup>99</sup> See, e.g., Letter from David T. Hirschmann, Senior Vice President, U.S. Chamber of Commerce, to Nancy M. Morris, Sec'y, U.S. Sec. & Exch. Comm'n (Oct. 2, 2007), *available at* <http://www.sec.gov/comments/s7-16-07/s71607-482.pdf> [hereinafter 2007 Chamber of Commerce Letter]; Letter from Keith F. Higgins, Comm. Chair, Comm. on Fed. Regulation of Sec. of the ABA Section of Bus. Law, to Nancy M. Morris, Sec'y, U.S. Sec. & Exch. Comm'n (Oct. 2, 2007), *available at* <http://www.sec.gov/comments/s7-17-07/s71707-126.pdf>; Letter from Anne M. Mulcahy, Chairman & CEO, Xerox Corp., and Chairman, Bus. Roundtable Corp. Governance Task Force, to Nancy M. Morris, Sec'y, U.S. Sec. & Exch. Comm'n (Oct. 1, 2007), *available at* <http://www.sec.gov/comments/s7-17-07/s71707-77.pdf>; Letter from Sullivan & Cromwell LLP to Nancy M. Morris, Sec'y, U.S. Sec. & Exch. Comm'n (Oct. 2, 2007), *available at* <http://www.sec.gov/comments/s7-16-07/s71607-458.pdf>; Letter from Wachtell, Lipton, Rosen & Katz to Nancy M. Morris, Sec'y, U.S. Sec. & Exch. Comm'n (Sept. 19, 2007), *available at* <http://www.sec.gov/comments/s7-16-07/s71607-190.pdf>.

<sup>100</sup> 2007 Chamber of Commerce Letter, *supra* note 98, at 2.

<sup>101</sup> See Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 34-56914, 72 Fed. Reg. 70450 (Dec. 6, 2007) (to be codified at 17 C.F.R. pt. 240). This rule was initially proposed in Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 34-56161, 72 Fed. Reg. 43488 (proposed July 27, 2007).

of these Proposal Opponents regarding opting out seems to depend on the nature of the default arrangement in place: they strongly support opting out when proxy access is the default, but strongly oppose opting out when no-access is the default. Although these Proposal Opponents have reversed their 2007 position and now support allowing shareholders to opt out of the current no-access default, this new position seems in reality to be part of an effort to avoid the adoption of a stronger proxy access regime by the SEC.

The second tension worth noting is between the Proposal Opponents' opposition to a proxy access regime that does not allow shareholders to opt out, and their acceptance of various arrangements that make it difficult for shareholders to replace directors, from which arrangements shareholders cannot opt out. Such arrangements have long existed under both federal law and state corporate law. For example, several of the federal proxy rules introduced in the 1950s with respect to consent solicitations have long made mounting proxy challenges more difficult and more costly.<sup>102</sup> Similarly, state law includes mandatory rules that prevent shareholders from initiating charter amendments.<sup>103</sup> To the best of our knowledge, none of the Proposal Opponents now championing opting out by shareholders from proxy access have expressed dissatisfaction about shareholders' inability to opt out of current arrangements that make it difficult to replace directors, or has proposed changes to facilitate such opting out. This is again consistent with the Proposal Opponents' fundamental commitment to arrangements that make electoral challenges more difficult rather than to arrangements that facilitate private ordering and opting out.

Finally, before proceeding, we should note that the Proposal Opponents substantially overstate the strength of the case for allowing opting out. The Proposal Opponents suggest that there can be no justification for not permitting opt-outs that would dilute the rights provided by a

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<sup>102</sup> See Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 645 (2003) ("In the 1950s, the SEC federalized proxy contests to make them harder for insurgents to win, moving even before states acted definitively."); *id.* at 613 ("The 1950s proxy rules, widely viewed as responses to managerial pressure, impeded insurgents." (citing John Pound, *Proxy Voting and the SEC: Investor Protection Versus Market Efficiency*, 29 J. FIN. ECON. 241, 263–67 (1991)). For another discussion of the proxy rules from this perspective, see Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793, 1805–07 (2006).

<sup>103</sup> See DEL. CODE ANN. tit. 8, § 242(b)(1) (2001).

federal access regime.<sup>104</sup> In fact, both state corporate law and federal securities law establish protections for shareholders, both in general and with respect to corporate elections, which shareholders cannot vote to dilute.<sup>105</sup> There is also a substantial body of academic work that identifies and discusses at length various reasons for adopting minimum standards of investor protection as mandatory rules from which opting out is not permitted.<sup>106</sup>

Moreover, it should be noted that the longstanding approach of the shareholder proposals rule has been to provide shareholders with minimum rights of access to the company’s proxy card for their proposals, and to allow companies to provide shareholders with additional rights, but not to derogate from the set minimum.<sup>107</sup> More generally, the proxy rules—and the securities laws in general—have long provided mandatory arrangements establishing a minimum level of protection for public investors, allowing companies to add additional protections, but not to reduce investors’ protections below the established minimum. Thus, an “asymmetric opting out” arrangement that allows opting out of the federal proxy access regime only to expand shareholder rights but not to weaken such rights would be consistent with the longstanding structure of the federal securities laws.

### *B. Opting out of the Federal Access Regime*

Although there is therefore a reasonable basis for supporting asymmetric opting out, we believe that the SEC should consider allowing “symmetric opting out”—that is, opting out of the

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<sup>104</sup> See, e.g., Grundfest, *supra* note 12, at 4-5 (viewing as irrational any proxy access regime that does not allow shareholders to opt out in order to weaken the rights provided to them by the regime).

<sup>105</sup> For example, state corporate law does not enable shareholders to opt out of their rights to vote on directors annually, and federal securities law does not enable shareholders to vote to approve their being furnished by proxy challengers with less information than is required by the proxy rules.

<sup>106</sup> For an early set of articles on the subject, see Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989). This symposium includes articles from authors representing different perspectives and methodologies—for example, Victor Brudney, Frank Easterbrook and Daniel Fischel, Robert Clark, and Jeffrey Gordon—who all support some limits on opting out. One of us has over time written extensively on the various reasons for placing some limits on opting out. See, e.g., Lucian Ayre Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713 (2003); Lucian Ayre Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989); Lucian Ayre Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

<sup>107</sup> See SEC v. Transamerica Corp., 163 F.2d 511, 517–18 (3d Cir. 1947).

proxy access regime either to strengthen or weaken the access rights of shareholders. One of the factors motivating us to take this position is the inevitable uncertainty about the optimal eligibility thresholds for proxy access in any given company. We believe that the difficulties shareholders face in opting out of default rules in the “direction” disfavored by the board—that is, toward less restrictive requirements for access—make it desirable to set reasonably low eligibility thresholds for the access default. However, if eligibility thresholds are set at a reasonably low level, it may be desirable in turn to allow shareholders to tighten those requirements if they consider more restrictive requirements to be preferable.

However, any opting out of the federal access regime should be permitted only if the opting-out process is designed in such a way that companies are released from the federal access regime if and only if their shareholders prefer a different arrangement. Below we discuss several principles that should govern such an opt-out process.

### *1. Opting Out Only by Majority Shareholder Approval*

We believe that boards of directors should not on their own be able to opt out of governance arrangements that make it more difficult to replace incumbent directors.<sup>108</sup> Thus, companies should not be able to opt out of a federal access regime by means of board-adopted bylaws. In our view, the federal access regime should allow opting out only by a shareholder resolution passed by shareholders representing a majority of the outstanding shares.<sup>109</sup> Boards should be free to initiate a vote on such a resolution, as should shareholders. With boards free to initiate votes on opt-out resolutions, such votes are likely to occur whenever passage of such opt-out resolutions is likely—that is, whenever a majority of the shareholders prefer to opt out of the access regime. Such opt-out resolutions, in their most basic form, would merely remove from the company’s shareholders the access rights provided by the federal access regime. However, as will be discussed below, such resolutions could be accompanied by proposals to adopt bylaws

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<sup>108</sup> For an analysis supporting this principle, see Bebchuk, *Shareholder Franchise*, *supra* note 23, at 709–11.

<sup>109</sup> A similar approach is used by section 216 of the Delaware General Corporation Law (“DGCL”), which prevents directors from repealing bylaws on majority voting that have been adopted by a vote of shareholders. DEL. CODE ANN. tit. 8, § 216 (2001 & Supp. 2008). Unfortunately, the DGCL does not extend this principle to other shareholder-adopted bylaws.

that would provide alternative access rights distinct from those conferred by the federal access regime.

### *2. Shareholder Ability to Reverse Earlier Opt-Out Decisions*

The process for opting out by shareholders from a federal access regime should leave the door open for shareholders to later reverse their choice and opt back in to proxy access. Shareholders' preferences may shift over time, with new information and as the shareholder body changes. The SEC's rules should therefore ensure that shareholders wishing to opt back in to the federal access regime do not face excessive impediments: opting back in should occur by the same process as opting out, and should be similarly easy.<sup>110</sup> In particular, any firm that is no longer subject to the federal access regime as the result of an opt-out resolution would again become subject to the access regime once shareholders representing a majority of the outstanding shares approve a resolution to that effect.<sup>111</sup> Public companies will therefore not be subject to the federal access regime only if (i) an opt-out resolution has been passed by shareholders representing a majority of the outstanding shares, and (ii) no subsequent resolution to opt back in to the federal access regime has been passed by shareholders representing a majority of outstanding shares.

### *3. Permissibility of Bylaws that Add to Access Rights Provided by Federal Law*

Firms should be free to adopt bylaws that allow shareholders additional rights to access the company's proxy card beyond the baseline rights provided by the federal securities laws—that is, either the access rights provided by the federal access regime, or a basis of no access rights if shareholders have adopted a resolution opting out of the federal access regime. If most

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<sup>110</sup> An alternative way to ensure that the non-applicability of the federal proxy access regime to a corporation continues to be supported by its shareholders is to have any decision to opt out of the access regime “sunset” after a fixed number of years. For example, the SEC could specify that a corporation is not subject to the federal proxy access regime if shareholders holding a majority of the outstanding shares approved a resolution (which was not subsequently reversed) to opt out of the access regime during the preceding five years.

<sup>111</sup> One advantage of having the opt-out done by shareholder resolution rather than by adoption of a bylaw is that companies may have charter provisions requiring a supermajority of shareholders to approve bylaw amendments; this would effectively make it much harder for shareholders who had opted out to later opt back in to a proxy access regime.

shareholders prefer an access regime that is more restrictive than the federal access regime, we would expect the board to initiate a resolution opting out of the federal access regime, coupled with a bylaw amendment to adopt the more restrictive access regime desired by shareholders. In this way, shareholders would be able to opt out into alternative and more restrictive access regimes instead of being able to opt out only into a no-access regime. If shareholders prefer a regime that provides more expansive access than the federal access regime, they should be able to adopt such an expansive access regime by augmenting the federal access regime with a bylaw providing additional access rights.

#### *4. Access to Arguments and Information Against Opting Out*

The SEC's rules should ensure that shareholders voting on a proposal to opt out of the federal proxy access regime have access to information explaining both sides of the issue. Without such a requirement, the company's proxy statement, distributed to all shareholders eligible to vote on the opt-out resolution, would contain only the views expressed by the company's board in favor of opting out—if a shareholder wished to present the case *against* opting out the shareholder would have to engage in a costly proxy solicitation. To ensure that shareholders voting on an opt-out proposal *are* informed about both sides of the issue, the SEC could consider requiring companies to include in their proxy materials a standard statement, drafted by the SEC, that explains the benefit to shareholders of proxy access provided by the federal regime.

#### *C. Beyond Proxy Access*

As we have discussed, the debate on proxy access has led public companies and corporate law firms to recognize and stress the value of allowing shareholders to opt out of governance arrangements. This recognition should lead as well to a general reconsideration of existing restrictions on shareholders' ability to opt out of governance arrangements that make it difficult for shareholders to replace directors. The adoption of SEC rules permitting shareholders to opt out of the federal access regime should be accompanied by such reconsideration. The SEC, Congress, and state legislatures should closely review these restrictions on shareholders opting out of the prevailing arrangements governing corporate elections.



Public officials could start by considering how to facilitate the ability of shareholders to, among other things, (i) opt in to annual elections in companies that currently have a staggered board, (ii) adopt bylaws governing elections without being required to include “fiduciary outs” that eliminate much of the bylaws’ potential significance, (iii) limit the use of poison pills that make it difficult to remove directors, and (iv) opt out of arrangements that make it difficult for institutional investors to coordinate their actions. We hope that the recent realization by many public corporations and corporate law firms of the value of private ordering and allowing shareholders to opt out of corporate governance arrangements will lead them to support such changes.

#### IV. CONCLUSION

This Article has sought to contribute to the debate on the SEC’s proxy access reform and governance reforms more generally. In particular, the Article has focused on “meta” objections that accept the desirability of reforms but argue that such reforms should be left to adoption through board action in response to shareholder proposals, against the background of the status quo default rule. There are strong reasons for replacing the current no-access default. In particular, there are reasons for believing that a proxy access regime is more likely to be efficient, and, moreover, that the greater difficulty of opting out where disfavored by the board (compared to where the board is in favor of opting out) provides a strong reason for adopting a federal access regime as a default. We further identify certain principles that should guide any opting out of the federal access regime. Our analysis has significant implications, beyond the proxy access debate, for the choice of corporate default arrangements in general and for the processes of opting out from such arrangements. We hope that our analysis will be useful to the SEC as it decides how to move forward with proxy access reform, as well as to future examinations of governance reforms in the critical areas of corporate elections and shareholder rights.