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The Case for Shareholder Access to the Ballot

Lucian Arye Bebchuk*

Abstract

The SEC is now considering a proposal to require some public companies to include in their proxy materials candidates for the board nominated by shareholders. I document that incumbents do not currently face any meaningful risk of being replaced via the ballot box, and I argue that providing shareholder access would be a moderate step toward improving board accountability. Analyzing each of the objections that opponents have raised against the proposed shareholder access, I conclude that none of them provides a good basis for opposing it. Indeed, it would be desirable to supplement shareholder access with additional measures to invigorate corporate elections.

Key words: corporate governance, directors, shareholders, shareholder voting, corporate elections, proxy fights, proxy contests, proxy rules, SEC.

JEL classification: D70, G30, G32, G34, G38, K22.

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* William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance, Harvard Law School; Research Associate, National Bureau of Economic Research. This paper builds on the comment letter that I sent to the SEC on the subject of possible changes in the proxy rules (<http://www.sec.gov/rules/other/s71003/labebchuk061303.htm>). I am grateful to Bob Clark, Marcel Kahan, Bob Pozen, BJ Trach, and members of the Harvard corporate governance group for helpful discussions and suggestions. I also wish to thank Fred Pollock, Rob Maynes, and Wei Yu for their research assistance, and the John M. Olin Center for Law, Economics, and Business for its financial support.

The paper was largely finalized before the SEC's recent adoption of a formal rule proposal. In writing it, I therefore focused on analyzing the basic pros and cons of the shareholder access regime considered in the Commission's initial release and in the subsequent report of the SEC staff. I added in footnotes commenting on the concretization in the formal rule proposal of the triggering event idea generally put forward in the staff report.

The Securities and Exchange Commission (SEC) last spring began a process of considering changes in the proxy rules that would require companies, under certain circumstances, to include in their proxy materials shareholder-nominated candidates for the board. Following an initial round of public comments, the SEC's Division of Corporation Finance recommended that the Commission propose for public comment rules that would provide such shareholder access.¹ Although most of the comments received thus far by the SEC have been in favor of reform, The Business Roundtable, other business associations, and prominent corporate law firms and bar groups, have all expressed opposition to shareholder access.² In their article in this issue of *The Business Lawyer*, Martin Lipton and Steven Rosenblum put forward a forceful statement of the main concerns and objections expressed by opponents of shareholder access.³ This paper seeks to put forward the case for shareholder access and to address the wide range of objections raised its opponents.

I begin by discussing why corporate elections need invigoration and how providing shareholder access would be a moderate step toward this goal. The main part of this Article then examines in detail each of the objections that opponents of shareholder access have put forward. I conclude that they do not provide a good basis for opposing shareholder access. I also point out that the available empirical evidence is supportive of such reform. After concluding that the case for shareholder access is strong, I suggest that it would be desirable and important to adopt additional measures to make shareholders' power to replace directors meaningful.

¹SEC STAFF REPORT: REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS 32–33 (July 15, 2003), at <http://www.sec.gov/news/studies/proxyreport.pdf> [hereinafter STAFF REPORT].

² All letter comments are available at <http://www.sec.gov/rules/other/s7103.shtml> (last visited October 9, 2003). Law firms and lawyer groups writing in opposition of shareholder access include the Association of the Bar of the City of New York ("NYC Bar"), the New York State Bar Association ("NY Bar"), the American Corporate Counsel Association (ACCA), Sullivan & Cromwell, and Wachtell, Lipton, Rosen, and Katz ("Wachtell, Lipton"). A comment letter that provided a detailed analysis of the different options, but refrained from taking a position, was submitted by the Task Force on Shareholder Proposal, American Bar Association (ABA) Section of Business Law. See Letter from David M. Silk, Chairman, Task Force on Potential Changes to the Proxy Rules, The Association of the Bar of the City of New York, to SEC (June 13, 2002), at <http://www.sec.gov/rules/other/s71003/tfpcprabny061303.htm> [hereinafter NYC Bar].

³ See Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. ____ (2003).

I. THE NEED FOR INVIGORATING CORPORATE ELECTIONS

The recent corporate governance crisis highlighted the importance of good board performance. Reforming corporate elections would improve the selection of directors and the incentives they face. Some supporters of shareholder access have “shareholder voice” and “corporate democracy” as objectives. But the case for shareholder access does not depend on having such. My analysis below will focus on the sole objective of effective corporate governance that enhances corporate value. From this perspective, increased shareholder power or participation would be desirable if and only if such a change would improve corporate performance and value.⁴

The identities and incentives of directors are extremely important because the corporate law system leaves, and must leave, a great deal of discretion in their hands. Directors make or approve important decisions, and courts defer to these decisions. Among other things, directors have the power to block high-premium acquisition offers, as well as to set the compensation (and thus shape the incentives) of the firm’s top executives.

How can we ensure that directors use their power well? In the structure of our corporate law, shareholder power to replace directors is supposed to provide an important safety valve. “If the shareholders are displeased with the action of their elected representatives,” stresses the Delaware Supreme Court in *Unocal*, “the powers of corporate democracy are at their disposal to turn the board out.”⁵ In theory, if directors fail to serve shareholders, or if they appear to lack the qualities necessary for doing so, shareholders have the power to replace them. This shareholder power, in turn, provides incumbent directors with incentives to serve shareholders well, making directors accountable. As Chancellor Allen observed, “[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”⁶

But the safety valve is missing. Although shareholder power to replace directors is supposed to be an important element of our corporate governance system, it is largely a myth. Attempts to replace directors are extremely rare, even

⁴ The objective of improved corporate performance (rather than increased shareholder voice) is one that my analysis shares with Lipton and Rosenblum’s article. We reach different conclusions, however, on whether shareholder access would serve this objective.

⁵ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A. 3d 946 (Del. 1985).

⁶ *Blasius Industries, Inc., v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

in firms that systematically under perform over a long period of time. By and large, directors nominated by the company run unopposed and their election is thus guaranteed. The key for a director's re-election is remaining on the firm's slate. Whether the nomination committee is controlled by the Chief Executive Officer (CEO) or by independent directors, incentives to serve the interests of those making nominations are not necessarily identical with incentives to maximize shareholder value.

To be sure, shareholders who are displeased with their board can nominate director candidates and then solicit proxies for them. The costs and difficulties involved in running such a proxy contest, however, make such contests quite rare. The initiation of contests is severely discouraged by a "public good" problem: those who run a proxy contest have to bear the costs themselves, but they would capture only a fraction of the corporate governance benefits that a successful contest would produce.⁷

Some opponents of shareholder access rely on the fact that, as the data put together by Georgeson Shareholder indicates, there were about forty cases of contested proxy solicitations last year.⁸ But a large fraction of the contests last year, as in preceding years, were conducted in the context of an acquisition attempt. Hostile bidders, for example, sometimes run a competing slate in order to overcome incumbents' opposition to an acquisition. Because hostile bidders have an interest in acquiring the target, the public good problem does not apply to them in the same way that it applies to challengers that seek to improve the firm's performance as a stand-alone entity.

I recently started a study of the cases of contested solicitations in the seven-year period 1996-2002, and the study's preliminary findings are provided in Table 1

⁷ ROBERT CHARLES CLARK, CORPORATE LAW 390–96 (1986). See Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1073, 1088-1096 (1990). See also "Symposium on Corporate Elections" (Lucian Bebchuk, ed.), Discussion Paper No. 448, Olin Center for Law, Economics, and Business, Harvard Law School (2003), available at www.law.harvard.edu/programs/olin_center/corporate_governance/papers.htm, at 62-64. (Sarah Teslik, executive director of the Council for Institutional Investors, describes how the costs of launching a proxy contest discourage challenges).

⁸ Letter from Wachtell, Lipton, Rosen & Katz, to Jonathan G. Katz, Secretary, SEC (June 11, 2003), at <http://www.sec.gov/rules/other/s71003/wachtell061103.htm> [hereinafter Wachtell, Lipton]. A list of all the cases of contested solicitation in 2002 is provided in Georgeson Shareholder, Annual; Corporate Review (2002), available at <http://www.georgesonshareholder.com/pdf/02wrapup.pdf>.

below.⁹ As the Table indicates, the majority of the contested solicitations did not involve attempts to replace the board with a new team that would run the firm differently. About a quarter of the cases did not involve the choice of directors at all, but rather other matters such as proposed bylaw amendments. Among the cases that did focus on elections for directors, a majority involved a fight over a possible sale of the company or over a possible opening or restructuring of a closed-end fund. Contests over the team that would run the (stand-alone) firm in the future occurred in about 80 companies, among the thousands that are publicly traded, during the seven-year period 1996-2002.¹⁰

Table 1
Contested Solicitations 1996-2002

<u>Year</u>	<u>Contested Solicitations</u>	<u>Contests Not Over Election of Directors</u>	<u>Director Contests over Sale, Acquisition, or Closed-End Fund Restructuring</u>	<u>Director Contests Over Alternate Management Team</u>
2002	38	5	19	14
2001	40	8	16	16
2000	30	6	17	7
1999	30	10	7	13
1998	20	1	6	13
1997	29	12	12	5
1996	28	11	8	9
Total	215	53	85	77

⁹ See Lucian Bebchuk, *The Myth of Corporate Elections* (Work in Progress). The starting point of the study was the data put together by Georgeson Shareholder listing all the contested solicitation cases in these seven years. See <http://www.georgesonshareholder.com/html/index1.asp?id=t17>. Documents filed with the SEC and available on EDGAR were then examined to determine the subject of the contested solicitation and the characteristics of the target company. I am grateful to Rob Maynes and Fred Pollock for their research assistance help with this project.

¹⁰ Because of the unavailability of some documents on EDGAR, it has not been possible thus far to classify six contests: four in 1996, one in 1998, and one in 1999. To be conservative, they were counted as contests over the team that will run the company as a stand-alone entity.

Furthermore, the firms in which the considered contests occurred were rather small. Of the firms in which such contests occurred, only 10 firms had a market capitalization exceeding \$200 million. The incidence of such contests for firms with a market capitalization exceeding \$200 million was hence rather small – less than two a year on average.

Thus, the safety valve of potential ouster via the ballot is currently not working. In the absence of an attempt to acquire the company, the prospect of being removed in a proxy contest is far too remote to provide directors with incentives to serve shareholders. Confronting poorly performing directors with a non-negligible risk of ouster by shareholders would produce such incentives. Determining the optimal magnitude of the removal threat, and the optimal incidence of challenges to incumbent directors, is difficult. But there are strong reasons to doubt that this incidence is practically zero. The case for at least making the electoral threat viable, rather than negligible, is strong.

II. THE MODERATE PROPOSAL OF SHAREHOLDER ACCESS

Under the shareholder access regime being considered, companies would have to include candidates nominated by qualified shareholders in the proxy materials sent to shareholders prior to the annual meeting. Thus, the materials sent by the firm to voting shareholders would sometimes give them a choice between candidates nominated by the board and one or more candidates nominated by qualified shareholders. By making it unnecessary for shareholder nominees to incur the expenses associated with sending materials to shareholders and obtaining proxies from them, this access to the “proxy machinery” would make it easier for shareholders to elect candidates other than those proposed by incumbent directors.

The proposal is a moderate step in the direction of invigorating elections. Indeed, as I explain below, stronger measures would be worth adopting. Several features combine to make the proposal a moderate step. First, the proposal would only apply to attempts to elect a minority of directors (a short slate). Second, even for such attempts, the proposal could reduce but would not eliminate the costs involved in an effective campaign for a shareholder-nominated candidate.

Third, the proposal would limit access to the proxy machinery to “qualified” shareholders or groups of shareholders that meet certain minimum ownership and holding requirements. Supporters of the shareholder access proposal suggest minimum ownership requirements, such as three percent to five percent, which could vary with firm size. The aim of these requirements is to screen nominations and allow only those whose support among shareholders is sufficient to indicate

significant dissatisfaction with the incumbent directors. To this end, one could also disqualify shareholders who nominated a short slate that failed to get a certain set threshold of support (say, twenty-five percent) from nominating another short slate for a certain period of time.

In addition, the SEC staff raised in its report a possible refinement of the access proposal that would further moderate a shareholder access regime. Qualified shareholders could be permitted to nominate a candidate only after the occurrence of “triggering events” that suggest the need for shareholder nomination.¹¹ Triggering events could include the approval of a shareholder proposal to activate the shareholder access rule or some other event indicating widespread dissatisfaction among shareholders.¹²

Requiring a triggering event would further moderate the effects of a shareholder access rule by limiting shareholder nominations to instances in which there is already strong evidence of widespread shareholder dissatisfaction. It would also provide boards with ample time to address shareholder concerns before shareholder nominations can be made.

Indeed, such a “triggering events” requirement might make an access rule too weak in some cases. Suppose that, shortly after the annual election of a given company, substantial shareholder dissatisfaction arose due to certain board actions or disclosures. In such a case, if a triggering event in the form of prior shareholder vote were required, it would take two annual elections until a shareholder nominee could be elected to the board. The delay could significantly reduce the rule’s effectiveness in facilitating desirable replacements quickly, as well as in supplying directors with incentives to serve shareholders. Indeed, such delay could make the rule ineffective in some of the cases where shareholder intervention might be most necessary.

Thus, if a triggering event were to be established, it would be worthwhile to provide a safety valve. In particular, it would be desirable to allow shareholder nomination even in the absence of a triggering event if support for the nomination

¹¹ STAFF REPORT, *supra* note 1 at 8–9.

¹² *Id.* at 9. The formal rule proposal released by the SEC after this article was largely finalized proposes two triggering events: (i) a shareholder proposal (submitted pursuant to Rule 14a-8) to subject the company to a shareholder access regime wins a majority of the votes cast, and (ii) at least one of the board’s nominees for directors receives “withhold” votes from 35% or more of the votes cast. See Proposed Rule: Security Holder Director Nominations, Securities and Exchange Commission, Release Nos. 34-48626.

exceeds an ownership threshold that is significantly higher than the threshold for nominations applying after the occurrence of a triggering event.¹³

It should be emphasized that the setting of threshold requirements for shareholder nominations would provide the SEC with a tool for ensuring that shareholder access works well. After the initial setting of the threshold, the SEC will subsequently be able to increase or lower the thresholds in light of the evidence. For example, if the ownership threshold set initially were to produce a substantial incidence of nominations that fail to attract significant support in the annual meeting, the SEC would be able to raise the threshold to reduce the incidence of such challenges. The use of ownership thresholds that can be adjusted as experience accumulates, and the possible addition of a triggering event requirement, contribute to making the shareholder access proposal a rather moderate measure with relatively little risk.

Although the shareholder access proposal would be a rather moderate step in a beneficial direction, any introduction of shareholder access would constitute a significant departure from incumbents' long-standing control of the proxy machinery. Thus, the access proposal has naturally attracted some strong opposition. Below I consider each of the objections that have been raised by critics to determine whether any of them provides a reasonable basis for opposing shareholder access.

III. CLAIMS THAT INDEPENDENT NOMINATING COMMITTEES MAKE SHAREHOLDER ACCESS UNNECESSARY

Opponents of shareholder access argue that it is unnecessary because shareholders already have, or will soon have, substantial power to advance the candidacy of directors they support. In particular, they stress shareholders' ability to propose candidates to the firm's nominating committee.¹⁴ This possibility, they argue, is especially important because pending stock exchange requirements would

¹³ The formal proposal just released by the SEC proposes a threshold of 5% ownership. See Proposed Rule, *supra* note 13. If this threshold were set for cases in which a triggering event occurred, it could also be established that a shareholder nomination could be made even without the prior occurrence of a triggering event if supported by, say, shareholders owning together 10%-15% of the company's stock.

¹⁴ See, e.g., E-mail from Henry A. McKinnell, Ph.D, Chairman and CEO, The Business Roundtable, to Jonathan G. Katz, Secretary, SEC (June 13, 2003), at <http://www.sec.gov/rules/other/s71003/brt061303.htm> [hereinafter The Business Roundtable].

require all future nominating committees to be staffed exclusively by independent directors.¹⁵ Such committees, so the argument goes, would be open to shareholder input. Indeed, some critics of shareholder access suggest that, at most, concern about nominations should lead to the adoption of rules that encourage nominating committees to give adequate consideration to shareholder suggestions.¹⁶

The critical question, of course, is whether nominating committees made of independent directors can be relied upon to nominate outside candidates whenever doing so would enjoy widespread support among shareholders. The answer to this question clearly depends on the directors' incentives and inclinations. By themselves, requirements that nominating committees comply with certain procedures or publish reports about their considerations can have only a limited effect.

Even if one accepts that nominating committees made of independent directors would do the right thing in many or most cases, independent nominating committees would not obviate the need for a safety valve. Director independence is not a magical cure-all. The independence of directors from the firm's executives does not imply that the directors are dependent on shareholders or otherwise induced to focus solely on shareholder interests.

Even assuming that the independence of the directors serving on the nominating committee would often lead to nomination decisions that would be best for shareholders, there would likely be some nominating committees that would fail to make desirable replacements of incumbent directors. Such failures might arise from private interest in self-perpetuation, because of cognitive dissonance tendencies to avoid admitting failure, or for other reasons. As long as such cases could occur, the safety valve of shareholder access would be beneficial.

Indeed, the cases in which shareholder access is needed are especially likely to be cases in which we cannot rely solely on the independence of the nominating committee. Suppose that there is a widespread concern among shareholders that a board with a majority of independent directors is failing to serve shareholder interests. It is precisely under such circumstances that the nominating committee cannot be relied on to make desirable replacements of members of the board or even of members of the committee itself--at least not unless shareholders have adequate means of applying pressure on the committee.

¹⁵ *Id.* at 3.

¹⁶ See, e.g., E-mail from John C. Wilcox, Vice Chairman, Georgeson Shareholder Communications Inc., to SEC 3 (May 22, 2003), at <http://www.sec.gov/rules/other/s71003/georgeson052203.htm> [hereinafter Georgeson].

Having the possibility of shareholder nominations in the background might improve the performance of nomination committees. The threat of shareholder nomination of director candidates might induce the nomination committee to take shareholder suggestions seriously in those circumstances in which such shareholder-nominated candidates would be in a position to attract substantial support. In such a case, although a shareholder nomination might not actually take place, the possibility of shareholder nomination would play a beneficial role. The existence of an independent nominating committee, in short, does not at all obviate the need for shareholder access. Such access would not be made unnecessary, but rather would nicely complement the future operation of independent nominating committees.

IV. CLAIMS THAT SHAREHOLDER ACCESS WOULD HAVE NO PRACTICAL EFFECTS

Opponents of shareholder access also argue that, even assuming that at present shareholders have little practical ability to replace directors, shareholder access would not change this reality. A shareholder access regime, it is argued, would not lead to the election of shareholder-nominated directors because it would not eliminate the costs of running a dissident slate and institutional investors tend to be passive.¹⁷

Most money managers indeed cannot be expected to initiate or to sponsor a dissident slate. As Robert Pozen explains in an earlier work and in this issue of *The Business Lawyer*, mutual funds are at most “reluctant activists.”¹⁸ Among other things, money managers would not wish to devote management time to a contest over one firm’s governance because they focus on trading and portfolio management, and they would wish to avoid any risk of litigation or company retaliation.

¹⁷ Letter from Robert Todd Lang, Co-Chair, the Task Force on Shareholders Proposals and Charles Nathan, Co-Chair, Task Force on Shareholders Proposals, ABA Section of Business Law, to the SEC 11 (June 13, 2003) available at <http://www.sec.gov/rules/other/s71003/aba061303.htm> [hereinafter ABA] (“New mechanisms to increase on a routine basis shareholder participation in director selection will not be worth their costs because they will not likely result in significant numbers of shareholder-nominated directors being elected.”).

¹⁸ Robert C. Pozen, *Institutional Investors: Reluctant Activists*, HARV. BUS. REV., Jan.–Feb. 1994, at 140, 140; Robert C. Pozen, *Institutional Perspective on Shareholder Nomination of Corporate Directors*, 59 BUS. LAW. ____ (2003).

It is reasonable to expect, however, that when other shareholders nominate a dissident short slate whose success would likely raise share value, such money managers would vote for this slate. The past voting patterns of private money managers indicate that they commonly do not vote against management on social issues, but they do occasionally vote against management on takeover issues when management appears to be value-decreasing. This pattern indicates that, although shareholder access would not lead to the election of shareholder-nominated directors who run on a social agenda or represent special interests, it would occasionally lead to the election of such directors when incumbents' performance is especially poor and the election of these directors holds the promise of an increase in shareholder value.

It is important to stress that the benefits of a shareholder access regime should not be measured by the number of shareholder-nominated directors that would be elected. Most benefits can be expected to arise without shareholder nominations actually taking place. The benefits would arise chiefly from the effect that shareholders' greater power would have on the incentives of directors and nominating committees.

Finally, suppose that shareholder access would have only a small or even negligible effect on the viability of an electoral challenge and thus on the accountability of incumbents. Such a conclusion could justify consideration of more expansive reforms of corporate elections. It could not, however, provide a basis for some critics' strong opposition to the proposal. If shareholder access would not noticeably change the current reality in which directors face a negligible threat of removal, there is no reason to be fiercely opposed to it. To provide a basis for strong opposition, opponents must show that shareholder access, rather than being practically insignificant, would have significant practical consequences that would be undesirable overall. I now turn to arguments that shareholder access would have significant costs.

V. POTENTIAL COSTS FROM THE OCCURRENCE OF CONTESTS

It is useful to distinguish between two types of costs that shareholder access could produce. One type, which I will discuss later on, would arise if shareholder-nominated directors were in fact elected. The other type, with which I shall begin, would arise from the mere occurrence of contests regardless of the outcome. Opponents of shareholder access name two ways in which the existence of contests would generate costs: (i) disruption and waste of resources caused by contested elections, and (ii) discouragement of potentially good directors from serving.

A. Disruption and Diversion of Resources

Critics paint a picture in which shareholder access would lead to a large-scale disruption of corporate management. They warn that, with shareholder access, contested elections would become the norm.¹⁹ Each contested election, in turn, would be “a tremendously disruptive event for [the] company.”²⁰ Threatened managers and directors would launch “a full-scale election contest, at least from the company’s side, replete with multiple mailings, institutional investor road shows and full page newspaper fight letters.”²¹ Such contests would require the company to incur substantial out-of-pocket costs, wasting company resources. More importantly, they would divert management’s effort and attention. The produced system of wide-scale elections, critics argue, “would be very unhealthy for our nation’s companies.”²²

There is no reason, however, to expect full-scale contests to become the norm. Indeed, under a well-designed access regime, full-scale contests that attract much attention from incumbents would occur only in a small minority of companies, where performance would likely be poor and shareholder dissatisfaction widespread.

To begin, in companies that would be adequately governed without widespread dissatisfaction among shareholders, the election of the company’s slate would be secure even if a qualified shareholder or shareholder group were to nominate a short slate. The past voting patterns of institutional investors clearly indicate that their voting *en masse* against management is the exception, occurring only in the presence of some strong reasons for doing so, rather than the norm. A shareholder nomination of a short slate, without broad shareholder dissatisfaction resulting from a poor record, would hardly require management to engage in a “full-scale” election effort.

Let us suppose, however, that the mere nomination of a short slate, no matter how slim its chances of success, would lead management to make a significant campaigning effort. The considered concern would still be warranted, because a well-designed access regime would not produce shareholder nomination in most

¹⁹ See, e.g., NYC Bar, *supra* note 2, at 4.

²⁰ Lipton & Rosenblum, *supra* note 3, at ____ (21)

²¹ ABA, *supra* note 14, at 11. The Business Roundtable warned that shareholder access “has the potential to turn every director election into a divisive proxy contest,” which would bring “[m]ultiple shareholder mailings, the engagement of proxy solicitors, and widespread public relations campaigns.” The Business Roundtable, *supra* note 11, at 4.

²² Wachtell, Lipton, *supra* note 9, at 2.

companies. The threshold requirements for making a nomination--as initially set and subsequently adjusted after experience is obtained--would ensure that shareholder nominations would not, as critics warn, become the norm.

Clearly, the incidence of shareholder nominations would depend on the threshold requirements set. Even in the absence of a triggering event requirement, a meaningful ownership requirement could substantially limit the incidence of contests. To be sure, if the requirements were set at a trivial level of ownership, nominations would likely become the norm. The higher the threshold, however, the lower the expected incidence of nominations. Indeed, if the minimum ownership required for nomination were set high enough, nominations would be exceedingly rare or even non-existent, and contests would remain as rare as they have been in the past.

If zero percent would open the gates too much, and fifty percent would leave them practically closed, there would likely be some intermediate level of ownership requirement at which contests would become more frequent but would remain far from being the norm. And if the SEC's initial setting of the threshold level turned out to produce too many contests, it could simply be raised. Furthermore, if shareholder access were conditioned on a prior majority vote in favor of it, the incidence of shareholder nomination would be quite limited even if the ownership threshold for making nominations were placed at a low level.

Note that the small number of companies in which contests would occur in any given year would not be randomly drawn from the set of all companies. Rather, they would likely be companies with high shareholder dissatisfaction and sub-par performance. Although contests would of course involve some costs, these costs would be a price worth paying for a process that could improve corporate governance in companies where such improvement might well be needed.

To concretize the above discussion, there is no reason to assume that shareholder access would necessarily raise the incidence of contested elections (outside the acquisition context) from negligible (even among poorly performing firms) to pervasive across all firms. Suppose that the incidence of such elections would go up from practically non-existent to, say, fifty or 100 a year, about one-half percent to one percent of the publicly-traded firms, with those 100 presumably concentrated among the companies with the greatest and most widespread dissatisfaction. The presence of such elections would also have an effect in a large number of other companies, where nomination committees would be more attentive to shareholders, but without any contest occurring. Thus, in such a state of affairs, which an appropriate design of the shareholder access rule could produce, the

disruption and resource diversion from the running of campaigns would be quite limited.

In short, critics concerned about contested elections becoming the norm should, at most, focus on ensuring that threshold requirements are set at levels that would not produce contests on a wide-scale basis. They should not argue for maintaining the current state of affairs in which such contests are practically non-existent outside the takeover context. This concern thus cannot justify a general objection to shareholder access.

Finally, and importantly, it should be stressed that the occurrence of actual contests in a small number of instances would hardly imply that the benefits of a shareholder access would be limited to this small number of companies. The presence of the shareholder access option might well operate to improve the selection and incentives of directors in many companies. Thus, while the costs and disruption from actual contests would be limited to a small number of cases each year, the benefits of having the shareholder access option would be system-wide.

B. *Deterring Potential Directors from Serving*

The occurrence of elections, opponents of shareholder access also argue, might deter some potentially good directors from serving on boards of publicly-traded companies.²³ Shareholder access, it is argued, “would dissuade from board service individuals who would be excellent directors but who are not prepared to stand for election in a contested election.”²⁴ Critics suggest that the increase in time commitment required by the Sarbanes-Oxley Act²⁵ already makes it “more difficult for many companies to find well-qualified individuals willing to commit the time required to serve as a director,” and that shareholder access “would likely exacerbate the retention and recruitment problem, resulting in an even smaller pool of well-qualified individuals willing to serve on corporate boards.”²⁶

Clearly, any position would be more attractive (and, other things equal, easier to fill) if the holder of the position were to be given complete security from removal. Firms elect not to grant most employees such security, however, even though doing

²³ Lipton & Rosenblum, *supra* note 3, at ____.

²⁴ ABA, *supra* note 14, at 21 (describing this objection); *see also* NYC Bar, *supra* note 2, at 6 (“An Access Proposal . . . is likely to create a disincentive for able candidates to seek, and for current members to continue with, board service.”).

²⁵ Pub. L. No. 107-204, 116 Stat. 745 (2002).

²⁶ NYC Bar, *supra* note 2, at 6.

so might well attract more job seekers and reduce the required level of compensation. In most cases, employers find that the benefits of retaining the power to replace employees--the ability to make desirable replacements and the provision of incentives to perform well--exceed its costs.

Because directors' use of their power and discretion can have major effects on corporate value, improving their selection and incentives is especially valuable. Thus, if shareholder access would improve director selection and incentives, that consideration should be given the most weight. Is there really no way to run the corporate system without the people at the very top of the pyramid not facing any risk of removal?

Note that, even with shareholder access, directors would face a rather small likelihood of removal relative to holders of other positions in the business world. Thus, it is far from clear that shareholder access would reduce the attractiveness of the well-paid and highly prestigious positions of directors. Even if shareholder access did make these positions somewhat less attractive, shareholders would be better off countering this effect with increased pay rather than with reduced accountability. Providing directors with complete job security as a means of attracting directors would be counterproductive.

VI. CLAIMS THAT SHAREHOLDER ACCESS WOULD PRODUCE WORSE BOARDS

I have thus far considered arguments that, regardless of the outcome, the mere existence of contests would harm companies and their shareholders. Critics also claim that, in those instances in which shareholder-nominated candidates would in fact be elected, additional costs would be imposed. In particular, critics claim that the election of shareholder-nominated candidates would (i) bring into the board "special interest directors," (ii) produce directors that would be less qualified and well-chosen than the company-nominated candidates, and (iii) produce balkanized and dysfunctional boards.

A. "Special Interest" Directors

Critics of shareholder access worry that it would facilitate the election of "special interest" directors.²⁷ Although the candidates chosen by the company would act in the best interests of all shareholders, it is argued, those nominated by

²⁷ See *id.* at 4-5; Lipton & Rosenblum, *supra* note 3, at ____.

shareholders would be commonly committed to advance the views, social or otherwise, of a small fraction of shareholders.

Shareholder-nominated directors, however, would not be elected without majority support. To be sure, if a group with a special interest had enough shares, it could nominate a candidate. But such a candidate would have no meaningful chance of obtaining the majority of votes necessary to be elected. Given the tendency of most money managers to support management and have their sole focus on shareholder value, a special interest candidate would not be able to attract their votes.

In considering the concern about special interest directors, it is important to distinguish between the shareholder access regime and cumulative voting. With cumulative voting, a special interest candidate that appeals only to a minority of the shareholders might be elected. Shareholder access, however, would not represent any departure from a majoritarian approach to filling each and every slot on the board. Unlike cumulative voting, shareholder access would not enable any candidate to be elected without a majority support among shareholders.

It might be argued that, even if elected by a majority of the shareholders, shareholder-nominated directors would serve the interests of the group that nominated them because they would wish to be renominated.²⁸ Interestingly, opponents making this argument are not willing to rely on the fact that elected directors have a fiduciary duty to serve the company and all of its shareholders--a fact to which they give much weight when assessing board nominations. In any event, to the extent that this issue is a significant concern, it could be addressed by stipulating that a shareholder-nominated candidate who was elected would appear automatically on the ballot in the next election. This provision would not ensure, of course, that this director would be re-elected. But it would ensure that the director's re-election would depend solely on how his or her contribution would be assessed by the majority of shareholders.

Finally, some critics believe that our experience with shareholder resolutions under Rule 14a-8 indicates that shareholder access would produce special interest directors.²⁹ Because special interest groups dominate the Rule 14a-8 arena, it is argued, they are also likely to play a central role in the nomination of directors. This inference, however, is unwarranted. Experience with shareholder resolutions

²⁸ See Letter from Michael J. Holliday, Chairman, Committee on Securities Regulation, Business Law Section of the New York State Bar Association, to SEC 6 (June 13, 2003), at <http://www.sec.gov/rules/other/s71003/scrblsnysba061303.htm> [hereinafter NY State Bar].

²⁹ See Lipton & Rosenblum, *supra* note 3, at ____.

indicates that resolutions that focus on social or special interest issues uniformly fail to gain a majority, receiving little support from mutual funds. The only resolutions that gain such support are those motivated by enhancing share value through dismantling takeover defenses. This experience confirms the view that shareholder access would not lead to the election of special interest directors.

Indeed, our experience with Rule 14a-8 resolutions does not even suggest that special interest directors would often run under a shareholder access regime. The resolutions that focus on social or special interest issues have been commonly brought by groups with a very small ownership percentage, which would not qualify under the more demanding ownership requirements contemplated for shareholder nominations.

B. *Bad Choices*

Critics also argue that shareholder-nominated directors would not be as well-qualified as candidates selected by the board. Shareholder-nominated candidates, it is argued, would not be as well chosen as candidates selected by the board. Instead, shareholders would nominate candidates lacking the necessary qualifications and quality, candidates who “would not likely be nominated by an incumbent board in the exercise of its fiduciary duties.”³⁰ The following concern expressed by The Business Roundtable is typical:

“For instance, a nominating committee may determine to seek out a board candidate who has desired industry or financial expertise However, as a result of shareholder access to the company proxy statement, such a candidate might fail to be elected because of the election of a shareholder-nominated director who does not possess such expertise.”³¹

Some critics also worry that the election of shareholder-nominated candidates would lead to the company’s non-compliance with various legal arrangements (e.g., New York Stock Exchange (NYSE) or NASDAQ requirements to have a majority of independent directors).³² This particular problem could presumably be addressed by allowing the company not to include in the proxy materials candidates whose election would lead to company non-compliance with governing rules and listing arrangements. But the raising of this concern reflects critics’ belief that shareholders

³⁰ NYC Bar, *supra* note 2, at 5.

³¹ The Business Roundtable, *supra* note 11, at 3.

³² *Id.*

electing a shareholder-nominated candidate would likely be making bad (or even stupid) choices.

Although opponents of shareholder access have little confidence in shareholder choices, they place a great deal of confidence in the choices made by nominating committees. One main reason given for this confidence is that independent directors have a fiduciary duty running to all shareholders. They can therefore be trusted to make the right choices, it is argued, unlike nominating shareholders who do not have the same duty to act in the best interests of the other shareholders of the corporation.³³

The question, however, is not whether nominating committees or qualified shareholders are better at selecting candidates. Granting that the former would commonly do a better job does not resolve the issue at hand. A shareholder-nominated candidate would be elected only with the support of a majority of the shareholders. Thus, the question is whether shareholders should ever be given a chance to prefer a shareholder-nominated candidate over a board-nominated candidate. There is little reason to expect that, in those occasions in which a majority of shareholders would choose a shareholder nominee over a board nominee, they would generally be making a mistake. As the U.S. Supreme Court stated in *Basic Inc., v. Levinson*, management should not “attribute to investors a child-like simplicity.”³⁴

First of all, if anyone has an interest to make choices that would be in the best interests of shareholders, the shareholders do. Even if nominating committees can be relied on to be solely concerned with shareholder interests most of the time, it is also possible that they would occasionally be influenced by other considerations. Accountability is important because the interests of an agent and principal do not always fully overlap. Shareholders, by definition, will always have an incentive to make choices that would serve shareholders.

Putting aside incentives, what about ability? Some critics stress that boards have better information and skills for selecting candidates for the board than do institutional shareholders.³⁵ Assuming this to be the case, however, does not imply that shareholders should not have the option to choose differently from what the board recommends. Although institutional shareholders might not have the same

³³ E-mail from Sullivan & Cromwell, LLP to Jonathan G. Katz, Secretary, SEC 3 (June 13, 2003) at <http://www.sec.gov/rules/other/s71003/sullivan061303.htm> [hereinafter Sullivan & Cromwell].

³⁴ 485 U.S. 224, 234 (1988) (quoting *Flamm v. Eberstadt*, 814 F.2d 1169, 1175 (7th Cir. 1987)).

³⁵ Lipton & Rosenblum, *supra* note 3, at ____.

skills and information, there is no reason to assume that they are unaware of the informational and other advantages possessed by the board and its nominating committee. Indeed, institutional shareholders usually display a substantial tendency to defer to the board. And they commonly would defer to the board's choices also under a shareholder access regime.

In some cases, however, the circumstances -- including, for example, the past record of the incumbent directors and the characteristics of a shareholder-nominated candidate--might lead shareholders to conclude that they would be better off voting for a particular shareholder-nominated candidate. Of course, shareholders might not always get it right. But given that their money is on the line, shareholders naturally would have incentives to make the decision that would best serve their interests. And there is no reason to expect that choices they would make in favor of a shareholder-nominated candidate would likely be wrong.

The substantial presence of institutional investors makes such a paternalistic attitude especially unwarranted. Institutions are likely to be aware of the informational advantage of the board and its nominating committee, and they can be expected to make reasonable decisions on whether deferring to them would be best overall. Indeed, institutions can hardly be regarded as excessively reluctant to defer to management. When circumstances convince shareholders to overcome their tendency to defer to management, there is little basis for a paternalistic view of their choices as misguided.

Critics also refer to "confusion" as a reason that shareholders electing a shareholder-nominated candidate might make a bad choice. Shareholders would be confused, it is argued, as to which nominees are supported by the incumbent board and which are supported by shareholder proponents.³⁶ But surely this is a technical issue that can be addressed. It should be possible to ensure that the company's materials would indicate in absolutely clear and salient ways which candidates are nominated by the board and which (if any) by qualified shareholders.

C. Balkanization

Even if an elected shareholder-nominated director would be a good choice standing alone, opponents of shareholder access argue, the choice would likely be a bad one because of its impact on the directors as a team. Directors, it is argued, should work harmoniously and collegially with each other and with the firm's top

³⁶ See, e.g., Sullivan & Cromwell, *supra* note 30, at 5; see also ABA, *supra* note 14, at 21.

executives. The election of a shareholder-nominated candidate, it is argued, would produce a balkanized, politicized, and dysfunctional board.³⁷

It is far from clear that the election of a shareholder nominee would produce such division and discord. As explained, elected directors would be unlikely to represent special, parochial interests not shared by the other directors. Rather, they would be candidates with appeal to a majority of the shareholders, including in all likelihood most money managers, and with commitment to enhancing shareholder value. Other directors should not be expected to have legitimate reasons either to be on guard against such shareholder-nominated directors or to treat them with suspicion.

In any event, institutional investors presumably would be aware of whatever costs in terms of board discord might result from the election of a shareholder-nominated candidate. This possibility would be one of the considerations they would take into account, and it would weigh in favor of the board candidates. Shareholder-nominated candidates thus would be elected only when shareholders would conclude that, notwithstanding the expected effects on board harmony, there were reasons (rooted, for example, in the board's past record) making the election of some shareholder-nominated candidates desirable overall. When board performance is poor enough and shareholder dissatisfaction is strong enough that shareholders would likely elect a shareholder-nominated candidate, it would be a mistake to preclude such nominations to protect board harmony.

VII. OTHER POTENTIAL COSTS

A. *Costs to Stakeholders*

Some opponents argue that, even if shareholder access were to make directors more attentive to shareholder interests, it could well make them *too* attentive.³⁸ The board, it is argued, should take into account not only the interests of shareholders but also the interests of other constituencies, such as creditors, employees, customers, and so forth. The board is supposed to balance all the competing interests of these groups. Permitting shareholders to nominate directors would put pressure on boards to focus on the interests of shareholders and neglect the interests of stakeholders.

³⁷ See Lipton & Rosenblum, *supra* note 3, at ____ ; see also NYC Bar, *supra* note 2, at 5; Wachtell, Lipton, *supra* note 9, at 2.

³⁸ See Lipton & Rosenblum, *supra* note 3, at ____.

It is far from clear, however, that insulating boards from shareholder nominations would benefit stakeholders. The interests of directors and executives are even less aligned with the interests of stakeholders than they are aligned with the interests of shareholders. Whereas directors often hold shares and options, they do not usually have any instruments that tie their wealth to that of bondholders or employees. And boards provide executive compensation schemes that are tied primarily to shareholder wealth.

Thus, there is no reason to expect that reduced accountability to shareholders would translate into increased attention to stakeholders. Limits on shareholder power thus should not be viewed as supporting the interests of stakeholders. Rather, it would enhance the unaccountable use of discretion by boards. By making directors accountable to no one and protecting them from removal even in the event of dismal performance, such limits would be costly to *both* shareholders and stakeholders.³⁹

B. *One Size Doesn't Fit All*

To conclude our discussion of potential costs, let us consider the claim that the access proposal wrongly imposes the same arrangement on a large universe of companies that vary greatly in their characteristics and circumstances.⁴⁰ One size, it is argued, does not fit all. Even if shareholder access would be beneficial for many firms, there would likely be others for which it would have no beneficial effects or would even have adverse effects.

If valid, however, this argument would at most imply that the adopted SEC rule should leave firms free to opt out of the rule with shareholder approval. For example, the adopted rule could provide shareholder access unless, following the adoption of the access rule, shareholders vote to adopt a charter or bylaw provision that opts out of the shareholder access regime. Indeed, if shareholder access were conditioned upon a prior shareholder vote to provide shareholder access, then

³⁹ For a general discussion of how stakeholder-based arguments do not provide a reasonable basis for limiting shareholder power, see LUCIAN ARYE BEBCHUCK, *THE CASE FOR EMPOWERING SHAREHOLDERS* (April 2003) (Harvard Law School Working Paper), available at <http://papers.ssrn.com/abstract=387940>, Part VI.

⁴⁰ See ABA, *supra* note 14, at 5 (noting “the diversity that exists among the roughly 14,000 publicly-owned companies, which vary greatly in size, industry, complexity, resources, ownership and other circumstances”).

qualified shareholders would not be able to make nominations unless a majority of shareholders affirmatively opted into such an arrangement.⁴¹

Thus, the considered argument cannot provide a basis for general opposition to an SEC rule that facilitates shareholder access. The argument at most implies that such a rule should make opting out possible; it should either provide shareholder access as a default arrangement from which firms could opt out with shareholders approval, or provide access as an arrangement into which shareholders would be able to opt.

VIII. NOW IS NOT THE TIME

In addition to questioning whether shareholder access was ever desirable, opponents also argue that, given recent reforms, now is not the time to consider shareholder access.⁴² These reforms include the 2002 Sarbanes-Oxley Act and the pending new listing standards of the stock exchanges. Opponents suggest that “any serious consideration of an Access Proposal . . . should not take place until the scope and effect of initiatives already implemented are fully understood.”⁴³ Given that it would take substantial time for companies to adjust fully to the reforms and for evidence about their effects to accumulate, these arguments imply that the shareholder access proposal should be shelved for at least several years.

One reason given for such a delay is that, when feasible, it is preferable to have changes made gradually. Adopting many substantial changes simultaneously

⁴¹ The formal rule proposal just released by the SEC enables shareholders to opt into a shareholder access arrangement by adopting a precatory resolution to this effect. See Proposed Rule, *supra* note 13. It should be noted, however, that the proposal would have companies subject to a shareholder access regime for only two years after the passage of such a precatory shareholder resolution. If one adopts the approach of letting shareholders make the choice, why not establish a shareholder access regime for a longer period of time if the adopted precatory resolution so specifies?

⁴² NYC Bar, *supra* note 2, at 3.

⁴³ *Id.* at 3; *see also* Letter from Broc Romanek, Chair, Corporate & Securities Law Committee, American Corporate Counsel Association, to John G. Katz, Secretary, SEC (June 13, 2003), at <http://www.sec.gov/rules/other/s71003/acca061303.htm> [hereinafter ACCA] (“Until the impact [of Sarbanes-Oxley Act] can more accurately be assessed, we believe it is appropriate to wait before making the proposed changes.”); Sullivan & Cromwell, *supra* note 30, at 2 (“Recent [c]orporate [g]overnance [r]eforms [s]hould [b]e [g]iven the [o]ppportunity to [w]ork [b]efore [f]urther [s]teps [a]re [t]aken.”); Lipton & Rosenblum, *supra* note 3, at ___. (29) (“[I]t seems only prudent to take the time to assess the impact of the far-reaching reforms we have just adopted.”).

might be difficult and destabilizing for firms. And recent reforms, it is suggested, are already “the most sweeping since at least the New Deal enactment of the basic federal securities laws.”⁴⁴

Adding shareholder access to recent reforms would indeed produce a big change in corporate governance. But the magnitude of the changes should not dissuade us from making it. The changes might well be the most sweeping since the New Deal, but the crises of corporate governance and investor confidence that has precipitated them are the most severe since the New Deal. Even with the addition of shareholder access, the scale of reforms would not be disproportionate to the magnitude of perceived problems.

The other reason given for waiting until the consequences of recent reforms are fully understood is that these reforms might by themselves fully address the problems for which shareholder access is proposed. Because the pending changes in stock exchange listing requirements would place the nomination of directors in the hands of independent directors, critics argue, they would “obviate the need for direct shareholder access to the issuer proxy statement.”⁴⁵

As explained earlier, the fact that directors are independent and selected by similarly independent directors does not by itself address all concerns about the selection and incentives of directors. It thus does not obviate the need for a safety valve: shareholders’ ability to replace directors in the event of widespread dissatisfaction with the independent board and nominating committee. With shareholder access in the background, independent nominating committees can be expected to make choices that will commonly leave the shareholder access route unused. But the independent nominating committee is not a substitute for shareholder access.

IX. THE EMPIRICAL EVIDENCE

Even if one believed that supporters of shareholder access had better arguments, opponents argue, significant changes should not be made without empirical evidence indicating that they would be beneficial overall.⁴⁶ Proponents of

⁴⁴ ABA, *supra* note 14, at 10; *see also* Lipton & Rosenblum, *supra* note 3, at _____. (“[Recent reforms] represent the most far-reaching set of new corporate regulation since the Securities Act of 1933 and the Securities Exchange Act of 1934.”).

⁴⁵ Sullivan & Cromwell *supra* note 30, at 3.

⁴⁶ NY State Bar, *supra* note 25, at 2.

shareholder access, they suggest, have not shouldered the burden of providing such evidence.

Requiring not only good policy reasons but also evidence that a change would be beneficial is a demanding test. In the case of many past reforms that proved to be beneficial, it would have not been possible to provide evidence that they would be beneficial before their adoption. In the case under consideration, however, there is nonetheless some solid empirical evidence that the direction in which the proposed reform would go--reducing incumbents' insulation from removal--would be beneficial.

A. *The Costs of Insulation*

There is substantial evidence that considerable insulation from removal via a takeover has adverse consequences on management performance and shareholder value. In a recent study Gompers, Ishii, and Metrick found a significant association between stronger antitakeover protections--and more generally, stronger insulation of management from shareholder intervention--and lower stock market valuation (as measured by Tobin's Q).⁴⁷ According to their study, throughout the 1990s companies with stronger antitakeover protection had a lower Tobin's Q, with the effect becoming more pronounced as the decade proceeded.⁴⁸

Furthermore, in a current study, Alma Cohen and I investigate how the market value of publicly traded firms is affected by protecting management from removal.⁴⁹ We find that staggered boards established by company charters are associated with a reduced market value. This reduction is economically significant, with a median of about 5% of market value. We also find evidence consistent with charter-based staggered boards causing, and not merely reflecting, a lower firm value.

Studies have also identified the many ways in which insulation reduces corporate value. Studies by Bertrand and Mullainathan, as well as by Garvey and Hanka, found that antitakeover statutes that provide strong protection from

⁴⁷ See Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107, 144–45 (2003).

⁴⁸ *Id.* This evidence is consistent with early evidence found by Morck, Shleifer, and Vishny on the association of managerial entrenchment with lower Tobin's Q. See Randall Morck, et.al, *Alternative Mechanisms for Corporate Control*, 79 AM. ECON. REV. 842, 851 (1989).

⁴⁹ See Lucian Bebchuk and Alma Cohen, *THE COSTS OF ENTRENCHED BOARDS* (Harvard Law School Working Paper, 2003), available at www.law.harvard.edu/faculty/bebchuk.

takeovers lead to increases in managerial slack.⁵⁰ Gompers, Ishii, and Metrick found that companies whose boards enjoy a wider array of insulating arrangements tend to have poorer operating performance—including lower profit margins, lower return on equity, and slower sales growth.⁵¹

There is also evidence that greater insulation results in higher consumption of private benefits. Borokhovich, Brunarski, and Parrino found that firms with stronger antitakeover defenses provide higher levels of executive compensation.⁵² Bertrand and Mullainathan obtained similar results for managers that are more protected due to antitakeover statutes.⁵³ Gompers, Ishii, and Metrick found that firms with stronger takeover defenses are more likely to engage in empire-building.⁵⁴

Furthermore, a study by Coates, Subramanian and I found that targets with strong takeover defenses, and in particular effective staggered boards, engage in value-decreasing resistance to hostile bids.⁵⁵ Targets of hostile bids that have an effective staggered board are much more likely to remain independent both in the short-run (twelve months) and in the long-run (thirty months) even though remaining independent makes their shareholders much worse off both in the short-run and in the long-run. On average, the shareholders of targets of hostile bids that have staggered boards earn returns that are lower by more than twenty percent.

To be sure, the empirical evidence discussed does not isolate the effects of giving or denying shareholders access to the corporate ballot. But the evidence indicates clearly that current levels of insulation are costly to shareholders and the economy. It thus provides general support for reforms that would reduce

⁵⁰ See Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535 (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) (concluding that antitakeover statutes "allow managers to pursue goals other than maximizing shareholder wealth").

⁵¹ See Gompers, Ishii & Metrick, *supra* note 39.

⁵² See Kenneth A. Borokhovich, Kelly R. Brunarski & Robert Parrino, *CEO Contracting and Antitakeover Amendments*, 52 J. FIN. 1495, 1515 (1997).

⁵³ See MARIANNE BERTRAND & SENDHIL MULLAINATHAN, EXECUTIVE COMPENSATION AND INCENTIVES: THE IMPACT OF TAKEOVER LEGISLATION 29 (December 1998) (Nat'l Bureau of Econ. Research, Working Paper No. 6830), *available at* <http://papers.nber.org/papers/W6830>.

⁵⁴ See Gompers, Ishii & Metrick, *supra* note 39, at 107.

⁵⁵ LUCIAN ARYE BEBCHUCK, ET.AL, THE POWER OF TAKEOVER DEFENSES 24–25 (July 2003) (Harvard Law School Working Paper, 2003), *available at* <http://www.nber.org/~confer/2003/si2003/papers/cf/bebchuk.pdf>.

management's insulation, and providing shareholder access to the ballot would be a moderate step in this general direction.

B. *The Effects of Independent Directors*

There is also some relevant empirical work on the relationship between director independence and corporate performance. The results are somewhat mixed.⁵⁶ Some studies find evidence that boards with a majority of independent directors perform better on some dimensions of corporate decision-making.⁵⁷ Other studies find no evidence that such boards perform better.⁵⁸ There is no solid evidence of a systematic correlation between having a majority of independent directors and corporate value and performance.⁵⁹

The above work provides no basis for critics' suggestions that having nominating committees staffed by (board-nominated) independent directors would be sufficient to ensure adequate selection and incentives for directors. Although such composition of nominating committees might improve matters, it cannot be relied on to obviate the need for the safety valve of shareholder nomination.

Could opponents of shareholder access claim that the above evidence also casts doubt on the benefits of the election of shareholder-nominated directors? If the benefits of independent directors have not received clear empirical verification, it might be argued, there is no reason to provide shareholder nomination of director candidates. The aim of shareholder access, however, is not to increase the number of independent directors (a result that pending stock exchange reforms will produce in any case). Rather, shareholder access reform aims at improving the selection of independent directors and their incentives. Independent directors nominated by shareholders would likely be different, in both their identities and their incentives,

⁵⁶ For a detailed survey of this work, see Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999).

⁵⁷ See, e.g., John W. Byrd & Kent A. Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids*, 32 J. FIN. ECON. 195, 219 (1992) (reporting that bidder returns are higher if firm has a majority of independent directors).

⁵⁸ See, e.g., Robert C. Hanson & Moon H. Song, *Managerial Ownership, Board Structure, and the Division of Gains in Divestitures*, 6 J. CORP. FIN. 55 (2000) (finding no evidence that boards with a majority of independent directors make better divestiture decisions); Bebchuk, Coates, & Subramanian, *supra* note 47, at 17–18 (finding no evidence that target boards with a majority of independent directors are less likely to resist and defeat value-increasing bids).

⁵⁹ See Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long Term Firm Performance*, 27 J. CORP. L. 231, 231 (2001).

than independent directors selected by boards under existing arrangements. Furthermore, studies about the effects that independent directors selected under current arrangements have do not capture the potential benefits that shareholder access would produce in terms of improved incentives for all directors. As explained, these benefits from reduced insulation and increased accountability might well constitute the biggest payoff from the shareholder access reform.

X. BEYOND THE CURRENT SHAREHOLDER ACCESS PROPOSAL

The proposal for shareholder access, I have argued, is a moderate reform in the right direction. In fact, it is too *moderate*. While adopting it would be a step worth taking, additional measures are necessary to make shareholders' power to replace directors meaningful.

A. *Beyond Access to the Company's Proxy Materials*

To facilitate a shareholder-nominated short slate, it would be desirable to do more than require companies to include such slates in the proxy materials. To have a meaningful chance of success, nominees would have to incur expenses to make their case effectively to the shareholders. This is all the more true given that, whenever incumbents face a meaningful chance of losing, they will likely spend substantial sums on campaigning. A group of shareholders holding, say, five percent of the shares might be unwilling to bear significant costs even if they believe that election of their nominee would enhance shareholder value.⁶⁰

In an earlier article about the problem of costs in proxy contests, Marcel Kahan and I concluded that it would be desirable to reform the rules governing the financing of proxy contests.⁶¹ We argued that such reforms are especially needed in cases--such as the case of a contest over a shareholder-nominated short slate--in which victory by shareholders would not provide them with control of the board. Under existing state corporate law, dissidents who gain control of the board in a proxy contest may reimburse themselves for the costs of their successful campaign. When control is not at stake, however, dissidents' success that improves the situation of the company would not produce a reimbursement of campaign costs. Accordingly, it would be desirable to ensure that, at least in the event that a

⁶⁰ CLARK, *supra* note 8, § 9.5, at 389–94.

⁶¹ See Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1073, 1135 (1990).

challenger in such contests attracts substantial shareholder support, the company would bear some or all of the challenger's campaign costs.⁶²

Thus, the SEC would do well to supplement a shareholder access rule with additional measures. In particular, the SEC should require that, if a nominee has sufficient initial support, companies will bear the costs of distributing to shareholders proxy statements by nominees who wish to have such materials distributed; companies would have the choice of either distributing such materials themselves or paying the challenger's reasonable expenses in doing so.⁶³

The SEC could further require that, when a nominee has sufficient initial support, companies bear reasonable costs incurred in connection with the proxy process (e.g., legal fees necessary for preparing a proxy statement).⁶⁴ Such support could be made dependent upon sufficient success in the ultimate vote or on the level of initial support for the candidate.

The above measures could be opposed, of course, on the grounds that they would be costly to shareholders. Shareholders, it might be argued, should not bear the costs resulting from the decision of a group holding five percent of the shares to nominate a director. As I explained above, however, an improved corporate elections process would be in the interests of companies and shareholders at large. Furthermore, the proposed additional measures would not require the expense of corporate resources on candidates whose chances of winning are negligible. Companies would be required to allocate resources only on the condition that a candidate has sufficient initial support and perhaps also on the condition that the candidate obtained sufficient support in the ultimate vote. The limited amounts that companies would have to spend under these measures would be a small price worth paying for an improved corporate governance system.

⁶² The concern that the costs of running a short slate would remain too high even if companies were required to include shareholder nominations in the company's requirement is shared by Pozen. See Pozen, *Institutional Perspective*, *supra* note 15.

⁶³ In a recent symposium on corporate elections, Damon Silvers, associate general counsel of the AFL-CIO, stressed that, in the case of a large cap company, the costs of printing and postage for just the first mailing are a "million dollar proposition," and a serious contest might require more than one mailing. See "Symposium on Corporate Elections," *supra* note 7, at 84. Since the company will be sending materials to the shareholders anyway, including proxy statements by qualified shareholder-nominated candidates would cost somewhat less than for the candidates to do a separate mailing.

⁶⁴ Damon Silvers also noted that the costs of getting a mailing "to the point where you can legally send it, meaning writing the documents and getting it through the SEC process is between 250,000 and 500,000 dollars, if it is not seriously contested." See *id.*, at 84.

B. *Beyond Short Slates*

As I emphasized, there is a strong need to enhance shareholders' ability to exercise their theoretical power to replace directors. In a choice between the *status quo* and the proposal under consideration for facilitating short slate nominations, the latter is clearly preferable. It would be even better, however, to go beyond the short slate proposal and to facilitate also the possibility of shareholders' replacing all or most of the directors.

Providing shareholders with an effective power to replace a majority of the directors would have a greater payoff in terms of improving corporate governance than facilitating short slates only would have. The election of a new team can ensure a change when change is needed. And facilitating contests for control might provide directors with strong incentives to serve shareholder interests.

Interestingly, shareholders might sometimes be willing to vote for a full slate nominated by some qualified shareholders even though they would be reluctant to vote for a short slate (which would produce a more modest change). The reason for this is that, even when shareholders prefer a change in governance, they might sometimes feel that electing a short slate would lead to discord on the board without effecting sufficient change. In such a case, shareholders might not be willing to vote for a dissident short slate, but, if given the opportunity, they might be willing to vote to replace the incumbent directors with a dissident full slate.

Of course, there would be cases in which shareholders would be willing to vote only for a short slate but not a full slate. In many cases, for example, institutions would not wish to change the general management team, but would wish to add a director to address a particular corporate governance issue, such as executive compensation. Under a regime that facilitates both short-slate nominations and full-slate nominations, dissatisfied shareholders could choose to put forward a short slate or a full slate depending on which would seem more likely to address the problems they perceive in the firm's current board.

There are various ways in which contests for control could be facilitated to make the threat of replacement more meaningful than it is today. The SEC could permit shareholders that meet certain threshold requirements (e.g., ownership, holding, or triggering event requirements) to include an alternative full-slate in the company's proxy materials. The SEC could also require that companies distribute to shareholders proxy statements made by such dissidents. The threshold requirements for full slate nomination might be different (and, in particular, more stringent) than those for short-slate nomination. I plan to discuss measures to

invigorate full-slate contests in future work. Here I wish only to point out the potential desirability of facilitating shareholder-nominated full slates.

XI. CONCLUSION

Opponents of shareholder access have raised a wide range of objections to such reform. An examination of these objections, however, indicates that they do not provide a good basis for opposing a well-designed shareholder access regime. Such reform would contribute to making directors more accountable and would improve corporate governance. The proposed shareholder access arrangement would be a moderate step in a beneficial direction.

While this step is worth taking, we must recognize that it is not sufficient. We should adopt additional measures to make meaningful shareholders' power to replace directors. Such measures are necessary to make directors genuinely accountable to shareholders.