Did Harvard Violate Federal Securities Law? SEC Commissioner Gallagher Thinks So

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Professor Lucian Bebchuk runs the Harvard Shareholder Rights Project, which helps investors filed proposals to be included in corporate proxies under Rule 14a-8. The Project has filed several precatory proposals to express shareholders' views that corporations should destagger their boards, arguing that research demonstrates that declassified boards improve corporate returns.

In a new paper posted to SSRN, SEC Commissioner Daniel Gallagher and Professor Joseph Grundfest accuse the Project of making misleading statements regarding the benefits of declassified boards. They suggest that Harvard could be vulnerable to lawsuits by shareholders or the SEC under Rule 14a-9, which forbids false statements in proxy solicitations. The paper, with the provocative title "Did Harvard Violate Federal Securities Law?" is discussed in the Wall Street Journal here.

The basic argument made by Gallagher and Grundfest is that the proposals misleadingly cite only research in favor of declassified boards, and fail to cite contradictory research.

Now, I have to say, I'm trying to evaluate how this claim would proceed if brought by a private shareholder, and I don't like its chances. First, as Gallagher and Grundfest admit, the proposals are precatory – so even if they succeed, they only have an effect if the corporate directors bow to investor pressure and choose to destagger the board. Gallagher and Grundfest argue that this is sufficient "causation" to constitute a Rule 14a-9 violation by analogizing to a case where management lied in *response* to a precatory shareholder proposal, and the court ordered a re-vote. But that case seems obviously distinguishable, because in that instance, the damage wrought by the misstatement was, in effect, damage to the right to offer proposals in the first place. And the shareholder had few options other than a truthful revote as a means of vindicating that right.

Here, of course, because the ostensibly misleading proposal is submitted by shareholders, and misstatements are not being used by management as a way to thwart shareholders, it's difficult to see what concrete harm the alleged misstatements are actually causing. Moreover, there are a variety of remedies for false statements beyond a private lawsuit: management can exclude proposals that are misleading, counter with its own information when opposing the proposal, or simply ignore the vote.

Apparently aware of the weaknesses in their causation theory, Gallagher and Grundfest also argue that these precatory proposals have a substantive effect sufficient to satisfy the causation requirement because proxy advisors like ISS often recommend voting against corporate directors who fail to declassify a board after a shareholder vote in favor of declassification. Corporate

directors may therefore feel pressure from ISS and vote in favor of declassification after a shareholder vote on the subject.

This chain of causation seems speculative, to say the least. First, not only are ISS's actions independent of the initial proposal, ISS's threats are only going to matter if there's a contested director election, and there usually isn't one. Even if votes are withheld from a director in a majority-vote corporation, the director will only actually lose his position if the Board accepts his resignation – which it may choose not to do if it concludes the voting was based on a misleading proxy proposal.

Second, the information that's allegedly omitted here – countervailing research on a contested subject – is publicly available. Leaving aside how that affects the analysis of the legal element of materiality (an omitted fact is only material if it affects the "total mix" of information available to shareholders, including public-domain information), if ISS pressure is a key step in the chain of causation, well, ISS is a sophisticated entity, as are the investors it advises – all of whom are no doubt capable of identifying and evaluating the research for themselves.

Finally, no damages would be available in a private action (because there's no chance of a shareholder demonstrating loss causation). The only remedy would be for a court to undo a vote in favor of the proposal and possibly order the re-staggering of a board – once again, difficult to imagine given the attenuated causation involved and the public nature of the omitted information.

That said, I'm fascinated by the fact that Commissioner Gallagher has chosen to fight this battle not in his capacity as Commissioner, but as the co-author of a paper posted to SSRN.* (The paper claims, one suspects disingenuously, Gallagher and Grundfest are not taking a position on the merits of declassification; they simply want to ensure that proxy proposals are truthful.) Despite the paper's suggestion that the SEC could bring an action against Harvard, the authors openly admit that the SEC's policy has *not* been to challenge statements made in these proposals, but simply to allow corporate managers to refute them in proxy materials. If anything, the goal of the article seems to be more about intimidating Bebchuk into altering the wording of his proposals (or intimidating Harvard into reining him in - the paper spends a bit of time on Harvard's responsibility for the Project), giving ammunition to corporate boards to resist such proposals, and firing a shot across the bow of proxy advisory firms that recommend in favor of such proposals. Commissioner Gallagher has long sought greater regulation of proxy advisors – winning new SEC guidance on the subject in June. In this article, Commissioner Gallagher seems to be dropping a hint that they should revise their recommendations or be subject to further investigation and regulation.

*Who does he think he is, a Delaware judge?