2009 SEC PROXY AMENDMENTS: A PROBLEMATIC SOLUTION TO SHAREHOLDER DIRECTOR NOMINATION

ARTICLE

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> The corporate election process, if it is to have any validity, must be conducted with scrupulous fairness and without any advantage being conferred or denied to any candidate or slate of candidates.
> -Vice Chancellor Hartnett[1]

I. INTRODUCTION

SHAREHOLDERS ELECT DIRECTORS, BUT THEY TYPICALLY DO NOT SELECT them.[2] THE apparent paradox of that statement has been the subject of significant discussion regarding the effectiveness of the corporate election process.[3] While corporate scholars generally agree that the shareholder election is intended to ensure that directors are accountable to shareholders, the

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1 Aprahamian v. HBO & Company, 531 A.2d 1204, 1206 (Del. Ch.1987).

2 *See* JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY 491 (Thomson West ed., 6th ed. 2007).

3 *See* discussion *infra* Parts I.B, I.C.

disagreement is whether it has that effect.[4] That disagreement has, consequently, resulted in debate over whether shareholders should have a more meaningful role in the selection of directors through proxy contests.[5] Under current election rules, shareholders may offer a competing slate of directors for election through a proxy contest, but significant costs in mounting such a contest serve as an effective barrier to pursuing that action.[6] Supporters of corporate election reform argue that the rules governing proxy contests should be amended to facilitate shareholders' ability to nominate and elect directors.[7]

On June 10, 2009, the Securities and Exchange Commission (SEC) proposed amendments to the federal proxy rules that would facilitate shareholders' ability to nominate directors to company boards of directors.[8] The amendments would allow nominees of dissident shareholders to avoid the full expense of a proxy campaign and the current requirement to print and mail their own proxy statement.[9] Instead, if shareholders met certain requirements, they could submit their nomination to the company, and the company would have to include it in their own proxy statement.[10]

Not surprisingly, the proposed amendments to the federal proxy rules have been very contentious. Since proposed, they generated more than 500 comment letters during the initial comment period,[11] and the SEC postponed its decision on the proposed amendments until 2010 to review the comments.[12] Recently, the SEC re-opened the comment period, and a final ruling is still pending.[13]

In this paper I argue that the SEC proposal is appropriate. However, *whether* proxy reform is appropriate is a separate question from *how* it should be accomplished. Although I agree with the SEC that shareholders eligible to nominate directors should be restricted to shareholders with long-term

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4 *See* discussion *infra* Parts I.B.

5 *Compare, e.g.*, Lucian Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007), *with* Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733 (2007).

6 *See* discussion *infra* Part I.A.

7 Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1085-86 (2008) (discussing the SEC's role on Proxy access and corporate elections).

8 Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29024 (proposed June 10, 2009) (to be codified at 17 CFR pts 200, 232, 240, 249 and 274).

9 *Id.*

10 *Id.*

11 Posting of Annette L. Nazareth to Harvard Law School Forum on Corporate Governance and Financial Regulation, http://blogs.law.harvard.edu/corpgov/2009/10/06/sec-urged-to-defer-adopting-proxy-access-rules/#more-4419 (October 6, 2009 at 9:01 am EST).

12 Jesse Westbrook, *SEC to Delay Proxy-Access Rule, Giving Banks Reprieve*, BLOOMBERG, Oct. 2, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aCVx6r4wx15Q.

13 Facilitating Shareholder Director Nominations, 74 Fed. Reg. 67144 (re-opening of comment period Dec. 14, 2009).

investment interests, I argue that the SEC's proposed one-year holding requirement—that shareholders who seek to have their nominees included in the proxy materials to have held their shares for at least one year—fails to identify those *long-term* shareholders.

Part I of this paper addresses the controversy over the director election process and whether proxy access should be facilitated. This discussion looks at the director election process in its current form as well as past occurrences of proxy contests. As I argue in the latter sections within this Part, the election process, including proxy contests, in its current form cannot be considered to ensure that directors are accountable to shareholder interests. Thus, the SEC's proposal to remove impediments to shareholders' rights to nominate and elect directors should be approved so that director accountability to shareholders is established. Furthermore, removing such impediments will have other benefits such as keeping U.S. corporations and its capital markets competitive on a global scale in addition to weakening arguments that shareholders should have more say on specific corporate matters—such as executive compensation—which intrude more directly into directors' decision-making functions.

Part II addresses the question of whether the SEC's specific proposals for facilitating shareholders are appropriate. As I argue in this section, because the SEC's proposal lacks a retention period following an election, the one-year holding requirement falls short of its purpose to restrict shareholders eligible to nominate directors to those shareholders that are long-term shareholders and, thus, more likely to have interests that are better aligned with other shareholders.

Relying on a recent study documenting stock value trends following proxy contests, in Part III I propose that the SEC's holding requirement include a minimum eighteen-month retention period of shares after an election if the shareholder's nominated director is elected. This retention period would effectively eliminate an incentive to nominate directors solely to achieve a short-term "spike" in stock value rather than to nominate directors that would contribute to the long-term success of the company. This Part ends with a discussion of the enforcement mechanism for the retention period. Part V then concludes.

II. Removing Impediments to Nominate and Elect Directors

This part begins with a discussion of the largely symbolic nature of the shareholder vote as a result of the election process in its current form. Included in this discussion is empirical evidence indicating that although proxy contests are available to shareholders, they are rarely used apart from a small population of hedge funds. Section B begins the discussion as to why facilitating shareholder proxy access is necessary to maintain the election process as an accountability mechanism. Section C discusses other benefits to facilitating shareholder proxy access.

A. Director Election in its Present Form

Corporate law textbooks often begin their discussion of the shareholders' role in corporations with a fundamental tenet of corporate law governance: shareholders elect directors, and the directors manage the business and affairs of the corporation.[14] But students of corporate law do not have to read far to learn that, despite that tenet, shareholders have no such power in publicly-held corporations. Rather, the shareholder vote is little more than a formality:

> Shareholders, to be sure, formally *elect* directors, but rarely do they play a meaningful role in *selecting* them. The rules governing proxy voting make it impractical for most shareholders to nominate or solicit support for board candidates. Incumbent directors, who control access to the corporation's proxy materials and can use corporate funds for proxy solicitations, effectively determine who is nominated—and thus who is elected. The corporation's CEO is far more likely to influence these decisions than any shareholder or shareholder group.[15]

The futility of the shareholder vote is evident even when considering recent shareholder "empowerment" measures such as majority voting or a withhold vote campaign.[16] First, a "holdover" default rule in many jurisdictions allows directors, who are not reelected as a result of majority voting or a withhold vote campaign, to stay on as director until a new director is elected.[17] And even without a holdover rule, directors are often simply reinstated, although they have failed to win the majority of votes.[18] Thus, the election process—regardless of whether it involves majority voting or a withhold vote campaign—remains a mere formality in the board's and chief executive's ultimate sole ability to select the board members.[19]

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14 *See, e.g.*, JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY 491 (Thomson West ed., 6th ed. 2007); LARRY R. SODERQUIST ET AL., CORPORATE LAW AND PRACTICE, 147 (Practicing Law Institute ed., 2nd ed. 1999).

15 BAUMAN ET AL., *supra* note 14, at 491.

16 *See generally* J.W. Verret, *Pandora's Ballot Box, Or a Proxy with Moxie? Majority Voting, Corporate Ballot Access and the Legend of Martin Lipton Re-Examined*, 62 BUS. LAW. 1007 (2007) (discussing the majority voting and withhold vote campaigns).

17 *See id.* at 1018-19 (noting that the MBCA recognized that the holdover rule in states such as Delaware make a majority voting bylaw largely symbolic).

18 Joann S. Lublin, *Director Lose Elections, but Not Seats; Staying Power of Board Members Raises Questions About Investor Democracy*, WALL ST. J., Sept. 28, 2009, at B4. (signaling that ninety-three board members at fifty companies in 2009 received fewer than 50% of votes cast during annual meetings, and none of those directors lost their position on the board—after directors failed to win majorities at the annual meetings, they submitted their resignations, but fellow directors simply reappointed them).

19 Ann M. Scarlett, *A Better Approach for Balancing Authority and Accountability in Shareholder Derivative Litigation*, 57 U. KAN. L. REV 39, 45 (2008) ("Even director elections are essentially determined by the existing board, because the existing board typically nominates the slate of directors on which shareholders then vote.").

Of course shareholders may nominate directors, but they can only do this through a costly proxy contest.[20] Still, all costs for the campaigns of the board's nominees are paid for out of corporate funds.[21] The inequity of that proxy access was expressed in a comment on the 2003 SEC proposal to facilitate shareholder proxy access:

> [Shareholders] can run their own slate of candidates, paying 100 percent of the costs, which may come to hundreds of thousands or even millions of dollars, for only a pro rata share of any increase in shareholder value as a result of the contested election. Meanwhile, management will spend the shareholders' money to fight them. This is not a level playing field. It is close to perpendicular.[22]

To be sure, the 2006 SEC e-proxy rule allowing for online proxy solicitation lowered proxy contest costs.[23] However, the SEC continues to recognize that shareholders still face significant costs in undertaking proxy contests.[24] Furthermore, although a decrease in costs resulting from the 2006 e-proxy SEC rule would perhaps result in a greater number of shareholder proposals, this has not happened. In an analysis of the 2008 proxy season by Georgeson Shareholder, a well-known proxy solicitation firm, Georgeson noted that the number of shareholder proposals submitted to companies on governance-related topics in 2008 was the fourth lowest out of the past five years—down 2% from 2007 and 15% from 2004.[25] Georgeson did note, however, that proxy contests increased significantly in 2007 and 2008; but Georgeson contributed the rise to factors such as the declining market and media focus rather than lower costs as a result of the 2006 SEC e-proxy rule.[26]

Given the costs associated with proxy contents, not surprisingly, shareholders have rarely offered their own competing slate of candidates; even in such instances, the success rates are unremarkable. Based on empirical evidence of director elections from October 1984 through September 1990, Joseph Grundfest noted that the probability of conducting a successful proxy contest

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20 *See* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with the Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 909 (1993).

21 BAUMAN ET AL., *supra* note 14, at 491-92.

22 Summary of Comments: In Response to the Commission's Proposed Rules Relating to Security Holder Director Nominations, Exchange Act Release No. 34-48626, http://www.sec.gov/rules/extra/s71903summary.htm (last visited May 9, 2010); *see also* Grundfest, *supra* note 20, 909 (illustrating the absence of incentive to conduct a proxy contest).

23 *See* Press Release, Securities and Exchange Commission 2006-209, SEC Votes to Adopt E-Proxy Rule Amendments and Propose Mandatory Model (Dec. 13, 2006), *available at* http://www.sec.gov/news/press/2006/2006-209.htm.

24 *2009 SEC Proposal*, *supra* note 8, at 29028.

25 Georgeson S'holder, 2008 ANNUAL CORPORATE GOVERNANCE REVIEW, (2008), at 4, http://www.georgesonshareholder.com/usa/download/acgr/acgr2008.pdf.

26 *Id.* at 8, fig. 19 at 46.

was only 0.175%.[27] Additionally, Lucian Bebchuk's more recent 2007 study indicated that from 1996 to 2005, incumbent directors faced a competing slate of candidates in only 118 elections.[28] Forty-five of the 118 elections were successful—an average of about 5 per year.[29] To roughly compare Bebchuk's data to Grundfest's earlier study, the probability of a proxy contest achieving any success in a single year from 1996 to 2005 was only 0.000633%.[30]

Indeed, proxy contests do occur, and the past several years have seen an increase in them.[31] However, those contests were almost entirely conducted by hedge funds.[32] And not only does hedge fund capital *pale in comparison* with capital from other investors,[33] but hedge funds, one researcher has noted, are not *normal* investors.[34] They primarily launch proxy fights for corporate control so that their short-term investment agendas can be carried out.[35] Certainly, the proxy rules should not exist for the almost exclusive use of a small population of hedge funds with relatively little capital in the markets and which pursue short-term results.

Ultimately, most shareholders offering a competing slate of directors not only face the reality that the costs of such a campaign are recovered only through a relatively minimal (and uncertain) increase in stock price, but they also face risk of not even being successful in having their slate elected. These

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27 Grundfest, *supra* note 20, at 862-63 n.17.

28 Bebchuk, *supra* note 5, at 685-86 tbl. 2.

29 *Id.* at 687 tbl. 4.

30 The percentage was arrived at by dividing the average successful proxy contests per year (5) with total 7896 firms listed on Amex, NASDAQ, and NYSE in 2001 which had individually 704, 4,378 and 2,814 registered firms, respectively. *See* U.S. GEN. ACCOUNTING OFFICE, SECURITIES REGULATION: IMPROVEMENTS NEEDED IN THE AMEX LISTING PROGRAM, 5 (2001), http://www.gao.gov/new.items/d0218.pdf. This is a similar method that Grundfest applied in arriving at his probability. *See* Grundfest, *supra* note 20, at 862, n.17. The much lower probability Bebchuk arrives at may reflect both a decrease in proxy contests in recent years as well as Bebchuk controlling for contested proxy solicitations that did not involve director replacement. *See* Bebchuk, *supra* note 5, at 684-85 (eliminating solicitations that involved matters such as whether a merger proposal should be approved or whether bylaws should be amended).

31 CHRIS CERNICH ET AL., INVESTOR RESPONSIBILITY RESEARCH CTR. INST., EFFECTIVENESS OF HYBRID BOARDS 5 (May 2009), http://www.irrcinstitute.org/pdf/IRRC_05_09_EffectiveHybridBoards.pdf (noting that from 2005 to 2008 proxy contests rose from 18 to 45).

32 *Id.* at 12 (noting that hedge funds initiated 89% of all proxy contests conducted between 2005 and 2008).

33 BARRY J. EICHENGREEN ET AL., HEDGE FUNDS AND FINANCIAL MARKET DYNAMICS 6 (Int'l Monetary Fund ed., 1998) (estimating that capital in hedge funds is just under $110 billion and capital in institutional investors exceeds $20 trillion).

34 Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: an Empirical Analysis,* 32 J. CORP. L. 681 (2007).

35 *Id. See also* Nadelle E. Grossman, *Turning a Short-Term Fling into a Long-Term Commitment: Board Duties in a New Era*, MICH. J. L. REFORM (forthcoming June 2009) (manuscript at 26-30, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1413949).

formidable risks make the proxy contest effectively impractical.[36] One commentator stated regarding the bleak reality of shareholder voting: "Democracy is a cruelly misleading word to describe the situation of the American shareholder."[37]

B. Promoting Director Accountability to Shareholders

If shareholders lack any meaningful ability to elect directors not nominated by the incumbent board and managers, why does corporate America even bother with shareholder election of directors? While the specific reasons for it may depend on one's theory of the firm,[38] corporate scholars agree that shareholder election of directors promotes accountability of directors to shareholders.[39] Bebchuk further notes that Delaware courts recognize the superior accountability mechanism of the shareholder power to replace directors and, consequently, the courts abstain from heavily scrutinizing director decisions.[40] To signify the Delaware courts' deference to director decisions as a result of the election process, Bebchuk quotes Chancellor Chandler in the *Disney* shareholder suit: "redress for [directors'] failures . . . must come . . . through the action of shareholders . . . and not from this Court."[41] Thus, the election process serves not only as a basis for director accountability, but it also serves to legitimize the exercise of power by the directors.[42]

Even opponents of shareholder empowerment initiatives note that shareholder election of directors serves as an important accountability mechanism. For example, in several articles, leading corporate governance

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36 The impracticality of the proxy contest, as supported by empirical evidence, severely weakens the assertion that a proxy contest is a viable option employed by shareholders. *See* Bebchuk, *supra* note 5, at 682 (noting the New York Bar Association inappropriately stated that "[u]nder the existing proxy rules, running an election contest is a viable alternative and a meaningful threat, and election contests occur regularly.").

37 *Special Report: Battling for corporate America—Shareholder democracy*, THE ECONOMIST, March 11, 2006, at 75 (quoting Bob Monks, a shareholder activist).

38 *Compare, e.g.*, ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Transaction Publishers 1991) (1932) (indicating that shareholders vote as owners of the corporation) *with* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989) (indicating that the shareholder vote arises out of a contractual relationship).

39 *See, e.g.*, Scarlett, *supra* note 19, at 45; Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV 547, 570 (2003). In the context of this paper, director accountability to shareholders is not intended to suggest that directors are accountable only to shareholders. As many have recognized recently, directors need to be cognizant of the interests of other stakeholders. E.g., Grossman, *supra* note 35; Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403 (2001).

40 *See* Bebchuk, *supra* note 5, at 680.

41 *Id.* (quoting In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005)).

42 *See also* Blasius Industries, Inc., v. Atlas Corp., 564 A.2d. 651, 659 ("[Voting] is critical to the theory that legitimizes the exercise of power by some (directors and officers) over vast aggregations of property that they do not own.").

scholar Stephen Bainbridge explains the role of the shareholder vote: "[Shareholder interest] is enforced indirectly through a complex and varied set of extrajudicial accountability mechanisms, of which shareholder voting is one."[43] Again Bainbridge states that the market for corporate control as an important accountability mechanism "depends on the existence of shareholder voting rights".[44]

Indeed, a proxy contest should be used sparingly so that directors have adequate freedom to make decisions affecting the business and affairs of the corporation.[45] However, the current form of the election process and, consequently, the role of the vote as an accountability mechanism beg the question: shareholder election of directors cannot promote accountability when the shareholder vote is largely a symbolic formality.

The intent of this paper is not to conclude that a higher proxy contest rate is needed; as Martin Lipton points out, concluding whether the annual rates of proxy contests are somehow too low is difficult.[46] But this author disagrees with Martin Lipton's presumption that the low number of contested elections "reflects the simple truths that director nomination process works" and "that incumbent directors are far more often than not the best people for the job."[47] An equally, if not more, reasonable presumption is that the low number of proxy contests is a result of the high costs of mounting a proxy contest coupled with only minimal potential benefits.[48]

Consequently, the low rate of proxy contests as a reflection that incumbent directors are "the best people for the job" can be considered reliable only if financial impediments to proxy contests are removed. Related to that, the election process as an adequate mechanism for director accountability can be established only if the ability of shareholders to select directors is based on their fundamental right to elect directors rather than on financial constraints impeding shareholders from considering a slate of directors not nominated by an incumbent regime. In arguing for greater shareholder proxy access in 2007, then-SEC Commissioner Annette L. Nazareth stated:

> [A] system in which there is a reasonable possibility that shareholders could nominate directors would serve as an important reminder to Boards that they are accountable to their shareholders. Even if a shareholder-nominated director

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43 Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1750 (2006).

44 Bainbridge, *supra* note 39, at 570.

45 Bainbridge, *supra* note 43, at 1750-52.

46 Lipton & Savitt, *supra* note 5, at 740.

47 *Id.*

48 *See* discussion *supra* Part I.A; *see also* Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1781 (2006) (stating that reimbursing shareholders for proxy contests would "help alleviate the real barrier to electoral challenges").

never is elected, the real possibility of that election would serve a useful purpose in maintaining Board accountability.[49]

C. Additional Benefits of Removing Impediments to Proxy Contests

Removing impediments to proxy contests will likely create benefits beyond simply establishing director accountability to shareholders. First, while opponents to any shareholder empowerment initiative have pointed to *past* performance of U.S. corporations to question whether any fundamental changes in corporate governance are needed,[50] the more important issue is whether failing to remove impediments may put U.S. corporations and its capital markets at a competitive disadvantage *in the future*. Two points can be made on that assertion: (1) other countries have been implementing laws that facilitate shareholder proxy access in foreign corporations; and (2) emerging evidence indicates that shareholder access to corporate ballots increases corporate value. Second, although a more indirect effect, opponents of shareholder empowerment initiatives should concede to removing proxy impediments because, as many have stated, having greater shareholder access to election proxies weakens the argument that shareholders should also have more say on other more specific matters—such as executive compensation—which would intrude more directly on director discretion in overseeing corporate matters.[51]

With regard to the first point, in 2006 the SEC stated that "[t]he strength of shareholder rights in publicly traded firms directly affects the health and efficient functioning of U.S. capital markets."[52] The SEC further noted that "[o]verall, shareholders of U.S. companies have fewer rights in a number of important areas than do their foreign competitors. This difference creates an important potential competitive problem for U.S. companies."[53] Accordingly, if increased shareholder rights increase corporate value, then the public would be much more willing to invest in those corporations allowing for such rights—which are currently foreign corporations.[54]

Specifically with regard to corporate value, the SEC found that "[s]hareholder rights serve the critical function of reducing the agency costs associated with the potential divergence of interests between professional

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49 Annette L. Nazareth, Comm'r, U.S. Sec. & Exch. Comm'n, Speech by SEC Commissioner: Opening Statement--Shareholder Proposals Relating to the Election of Directors (Nov. 28, 2007) (transcript *available at* http:// www.sec.gov/news/speech/2007/spch112807aln.htm).

50 *E.g.*, Lipton & Savitt,, *supra* note 5, at 734.

51 *American Corporate Governance: Hail, Shareholder!*, THE ECONOMIST, June 2, 2007, at 65.

52 COMM. ON CAPITAL MKT. REGULATION, INTERIM REPORT OF THE COMM. ON CAPITAL MKTS REGULATION 16 (Nov. 30, 2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

53 *Id.*

54 *Id.*

managers and dispersed public shareholders."[55] Absent sufficient shareholder rights, however, investors reduce the value of shares due to the expected higher agency costs.[56] Because U.S. corporate law lags behind in shareholder rights when compared to foreign law, that affects both the value of U.S. corporations and its public markets: U.S. corporations are valued less than their potential as a result of inadequate shareholder rights, and foreign corporations likewise would have "an incentive either not to enter the U.S. public markets in the first place or to exit them in response to inadequate legal protection of shareholder rights."[57]

Additionally, emerging evidence suggests that shareholder access to the corporate ballot improves corporate value. A recent 2009 study by Investor Responsibility Research Center Institute (IRRC) analyzed 120 "hybrid boards"—boards with members elected from proxy contests—formed from 2005 through 2008.[58] On average, from the beginning of the contest period through the first year of a hybrid board's existence, those companies' total share price returns were 19.1 percent—16.6 percentage points better than peers' total returns.[59] And the outperformance may not simply be a fleeting result of temporary higher bidding of shares by those who thought the company was underperforming and undervalued: initial results show that total share price performance through the three-year anniversary of a sample of fifteen hybrid boards averaged 21.5 percent—almost 18 percentage points more than their peers.[60] Although the increased share price was an average and companies with hybrid boards did not equally share in the same success,[61] the ability to mount a proxy contest appears to often translate into increased corporate value.

Finally, a more indirect benefit of increasing access to proxy contests is that it weakens the recent call for other shareholder empowerment initiatives pertaining to specific business matters.[62] As Stephen Bainbridge has noted,

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55 *Id.*

56 *Id.*

57 *Id.*

58 CERNICH ET AL., *supra* note 31, at 3.

59 *Id.* at 28.

60 *Id.* at 28. Perhaps contradicting his own position, Martin Lipton even notes evidence that proxy contests improve corporate performance. *See* Lipton & Savitt, supra note 5, at 742-43 n.31 (quoting Steven Gray, *Bigger Than They Look: How Can Investors with Small Stakes Have Such a Large Impact in Proxy Fights?*, WALL ST. J., Oct. 9, 2006, at R6.) In his parenthetical to that cite, Lipton writes "noting that a rising trend in proxy contests by small stakeholders is 'likely to persist, largely because investors are increasingly impressed with the improved performance at companies [where such proxy contests have succeeded]".

61 CERNICH ET AL., *supra* note 31, at 36 (noting that bankruptcy resulted in 5% of businesses in the sample of hybrid board, although the authors did not know if that was in fact a result of the hybrid boards).

62 *See, e.g.*, American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115, 516 (2009) (applying "say on pay" to companies receiving Troubled Asset Relief Program (TARP) funds); Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong.

efficiency in corporate decision-making can only be established by "[a]chieving an appropriate balance between authority and accountability."[63] However, those accountability mechanism initiatives—such as shareholder approval of executive compensation—make the decision-making process of corporate boards less efficient because they intrude more directly into directors' decision-making functions.[64]

Rather, the proper balance should be achieved through improving shareholder access to the corporate ballot. As discussed above, legitimacy of directors to freely exercise their business judgments is partly a result of the shareholder election.[65] But because the shareholder vote as it presently exists is largely symbolic, then perhaps directors' decisions should be subject to federally-mandated referenda on specific corporate issues.[66] Alternatively, if shareholders are given adequate ability to elect their directors through more competitive elections, then directors accordingly should be given greater freedom to make decisions affecting the business and affairs of the corporation without input from shareholders.[67] One researcher expressed that latter view:

> [H]arried managers may conclude that the best approach is to adopt corporate-governance reforms that increase shareholder democracy and so give them a stronger mandate. If shareholders are able to elect directors and hold them properly accountable for their performance, then they should be more willing to let them get on with the job.[68]

III. Shortcomings of the Long-term Requirement

The equally important question to whether shareholders should have greater access to the corporate ballot is precisely how to accomplish that. To restate, the SEC's proposed amendments to the federal proxy rules gives shareholders greater access to the corporate ballot, provided that a nominating shareholder meets certain requirements. One important condition to shareholders' ability to nominate directors under the current SEC proposal is the SEC's one-year holding

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(seeking to regulate the executive compensation, partly through a "say on pay" provision, regardless of whether a corporation receives TARP funds).

63 Bainbridge, *supra* note 39, at 605.

64 *Id.*

65 *See supra* note 42 and accompanying text.

66 *See* Strine, *supra* note 7, at 1104 ("[Opponents'] argument against [the federal 'say on pay'] bill, however is weakened by the lack of progress on proxy access for election reform proposals.").

67 *See Id.*

68 *Hail, Shareholder!, supra* note 51; *see also* Julian Velasco, *Taking Shareholder Rights Seriously,* 41 U.C. DAVIS L. REV. 605, 662, 664 (2007) (stating that "[c]onsistent with their right to elect directors, shareholders should be permitted to nominate director candidates" but that shareholder "say on pay" is not a proper subject for shareholder action because "[u]nder state corporate law, directors have responsibility for setting officers' salaries, and shareholders do not have any say on the matter").

requirement.[69] It requires shareholders who seek to have their nominees included in the proxy materials to have held their shares for at least one year.[70] The purpose of the requirement is to restrict shareholders seeking proxy access to those with long-term interests, thus eliminating shareholders that may use a proxy contest for short-term gain.[71]

However, the one-year holding requirement falls short of its intended purpose. Rather, despite the holding requirement, the proposed proxy amendments present a powerful incentive to use them solely for short-term gain—specifically, taking advantage of the short-term "spike" in share value that typically follows proxy contests.[72]

Superficially, the requirement appears adequate for its intended purpose (although the SEC does not go into any depth as to the reasons behind the requirement). The one-year requirement presumably reflects the idea that shareholders do not need to have long holding periods because stock price reflects long-term value of a company and, thus, long-term value matters to all shareholders—regardless of whether they are short- or long-term shareholders. If a shareholder would want to change directors through a proxy contest, the shareholder would want to make a change that helps the company in the long term because that helps present stock price value.[73] Also, the one-year holding requirement theoretically eliminates many powerful short-term investors such as hedge funds, who typically only hold shares for an average of one and one-half quarters—consistent with their short-term investment practices.[74]

However, the one-year requirement does not adequately eliminate those shareholders that may use the proxy contest for short-term gain. First, initial analysis of comments in response to the SEC proposal suggests overwhelming support for it, but, interestingly, hedge funds favor the one-year holding period.[75] As the subsequent discussion will explain, while the one-year holding requirement does not entail a "short-term" investment in the traditional sense, the holding requirement does not eliminate incentives to seek purely short-term gain. Along with the fact that "activist" hedge funds hold onto their shares for one year or more,[76] that short-term incentive is likely why hedge funds do not

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69 *2009 SEC Proposal*, *supra* note 8, at 29037.

70 *Id.*

71 *Id.*

72 *See* discussion *infra*.

73 *See* William W. Bratton, *Supersize Pay, Incentive Compatibility and the Volatile Shareholder Interest*, 1 VA. L. & BUS. REV. 55, 67 (2006).

74 Robin Greenwood & Michael Schor, *Hedge Fund Investor Activism and Takeovers* 13 (Harvard Bus. Sch. Working Papers, Paper No. 08-004) (July 2007), *available at* http://www.hbs.edu/research/pdf/08-004.pdf.

75 Nazareth, *supra* note 11.

76 Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008), http://www.columbia.edu/~wj2006/HFActivism.pdf (finding that the holding period for activist hedge funds average from one year to 20 months).

view the one-year holding requirement as an obstacle to their short-term investment practices.

Second, with regard to share price reflecting the long-term value of a company, although long-term value may "matter" to all shareholders, a consistent shareholder perspective on value cannot be assumed.[77] As many have noted, "shareholder preference respecting investment policy, financial reporting, and payout policy vary with behavioral characteristics, time horizons, and the state of the market."[78] Thus, although all shareholders may be concerned with long-term value, shareholders do not always act rationally or primarily with a firm's long-term success in mind.[79]

For example, a shareholder, despite holding onto shares for one or even more than one year, may be enticed by an opportunity to achieve a short-term increase in stock price, regardless of its long-term effects.[80] William Bratton recognized this perverse short-term incentive with regard to stock options in executive compensation packages.[81] He noted that even stock options that have long vesting periods (such as the prevailing ten year duration) but are set to vest in the near future lure executives to manage for the short-term in order to quickly increase stock value as the vesting period nears.[82] If executives will soon acquire stock through option exercise, they have an incentive to choose a "glamour investment," although "[f]rom a long-term, fundamental value point of view, the glamour investment is sub-optimal."[83]

The perverse incentive inherent in stock options is also present in the context of proxy contests regardless of the SEC's proposed holding requirement. The above-mentioned IRRC proxy contest study indicates that share price spikes immediately after contested elections because investors perceive the proxy contest as an indication that the company was underperforming and undervalued.[84] Accordingly, the incentive for a shareholder to mount a proxy contest may be simply to achieve that short-term "spike" in value—especially if a company's stock price had been showing a lack of upward movement—rather than establishing true long-term success for the company. Once the short-term spike is achieved, the shareholder can simply sell its shares to capitalize on the increased value.

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77 *See* Bratton, *supra* note 73, 67-68.

78 *Id.*; *see generally* Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635 (2002-2003) (discussing the fallacy of the Efficient Capital Market Hypothesis, which fails to capture the true value of companies due in large part to shareholder behavior).

79 *Id.*

80 *See* Bratton, *supra* note 73, at 71-73 (discussing perverse incentives inherent in stock options).

81 *Id.*

82 *Id.*

83 *Id.* Bratton defines a "glamour investment" as a high-risk, and potentially high-return investment. *Id.* at 71-72.

84 CERNICH ET AL., *supra* note 31, at 33-35.

Thus, the shortcoming of the holding requirement is that it fails to ensure that shareholders, who exercise their right to nominate a director once the right vests by way of the holding requirement, continue to have a significant economic interest in the company following the election. Similar to Bratton's analysis of stock options, here, simply because a shareholder's right to nominate a director vests as a result of meeting the one-year holding requirement, that holding period does not necessarily direct shareholders to nominate directors out of an incentive to create long-term value for the company. Rather, a shareholder, in order to achieve a short-term stock value spike typically associated with a proxy contest,[85] has an incentive to nominate a "glamorous" director—regardless of whether that director may be sub-optimal from a long-term value point of view—and then sell its shares to capitalize on their short-term increased value.

As a final note, the SEC-proposed requirement that nominating shareholders sign a statement disclosing their intent to continue to own their shares through the annual meeting and after the election cannot be considered an adequate measure to ensure that shareholders nominate directors out of long-term interests. First, the statement and disclosures appear to have no binding effect or repercussions associated with them if disregarded.[86] In fact, the SEC proposal even states that the "nominating shareholder or group would not be bound by the same fiduciary duties applicable to the members of a board's nominating committee in selecting director nominees."[87] Second, the hypothetical situation discussed above notes that simply holding the share through the meeting or until the next election does not eliminate the incentive to mount a proxy contest out of short-term interests or, in the words of the SEC, to ensure that a shareholder "continue[s] to have a significant economic interest in the company following the election."[88] Ultimately, the SEC's proposed one-year holding requirement does not ensure that only shareholders with long-term interest are eligible to nominate directors.

IV. Time Holds the Cure: Correcting the Long-term Shortcoming

The shortcoming of the one-year holding requirement is a result of the lack of an adequate requirement that shareholders retain their shares if their nominated director is elected. In the context of stock options, Bratton recognized that the perverse incentives for executives to manage for the short-term, in order to achieve a spike in share value upon an option vesting, was a result of the lack of a retention requirement on shares acquired through stock

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85 *See* discussion *supra* Part II.

86 *See 2009 SEC Proposal*, *supra* note 8, at 29047.

87 *Id.*

88 *Id.* at 20937.

options.[89] Given the similar criticisms of stock options and the proposed SEC holding requirement, Bratton's general recommendations to eliminate short-term incentives inherent in stock options provide general guidance as to how to improve upon the holding requirement.[90] Above all, the holding requirement must restrict alienation of shares *even after* a shareholder exercises itsright to nominate a director and that director is elected.[91] The restriction on alienation aligns the shareholder's incentive to nominate a director with a firm's long-term success, and thus the long-term shareholder interest.

A duration requirement can be recommended based on the IRRC study.[92] The IRRC study indicates that the short-term "spike" in share value occurred during the standard three month contest period (average increase of 9.8 percent) and in the twelve months following the contest (average increase of 5.0 percent)—both periods outperforming peers.[93] Following those periods, share price increased just 0.7 percent—6.6 percentage points worse than peers (although still outperforming peers overall).[94] Based on those statistical trends, a shareholder with a short-term interest would sell the stock within a year of the election.

Thus, the share retention period following the election of a nominated director should be set at a minimum of eighteen months. This would bypass the short-term "spike" and put the holding of shareholders' stock into the months where the share value "spike" levels off. Having that retention requirement forces a nominating shareholder to look past the share value spike period and nominate a director out of long-term interests rather than a short-term incentive.

The mechanism for enforcing the retention requirement can be modeled after Section 16(b) of the Securities Exchange Act.[95] Section 16(b) imposes liability on listed insider short-swing profits, where listed insiders are required to disgorge to the issuer any profit realized as a result of a purchase and sale of covered equity securities occurring within a six month period.[96] Applying section 16(b) in the context of proxy contests, the SEC can require disgorgement of any profit realized by a nominating shareholder who sells its shares prior to the end of the eighteen month retention period. Also, similar to section 16(b), recovery of the profit will be either enforced by the issuer or a shareholder suing on its behalf.[97] Thus, the potential for liability will not only have a deterrent

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89 Bratton, *supra* note 73, at 75.

90 *See Id.*

91 *See Id.*

92 CERNICH ET AL., *supra* note 31.

93 *Id.* at 27.

94 *Id.*

95 15 U.S.C.A § 78p (West 2009).

96 *Id.*

97 *See Id.*

effect, but any action seeking profit disgorgement for abuse of the new proxy rules will be left to the discretion of the firm or its shareholders.

V. CONCLUSION

Facilitating shareholders' ability to mount a proxy contest is needed. Nevertheless, the recent SEC proposal to amended the rules regarding proxy contests needs to be implemented with due caution. As stated, "[t]he most direct way for . . . investors to influence corporate policy is to elect corporate directors they believe will support their interests."[98] Thus, it is important that investors nominating directors through a proxy contest have the company's long-term success in mind.

The proposed SEC amendments to the proxy contest rules recognize that shareholders eligible to nominate directors should be restricted to long-term shareholders and not include shareholders who may use the new proxy rules solely for short-term gain. However, the one-year holding requirement as proposed by the SEC does not adequately control for that latter possibility. The new proxy rules should include a retention period for shares following the election of a nominated director; that retention period should be a minimum of eighteen months.

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98 Frank S. Partnoy & Randall S. Thomas, *Gap Filling, Hedge Funds, and Financial Innovation* (Oct. 2006), (manuscript at 9), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=931254.