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SETTING OPTIMAL RULES FOR SHAREHOLDER PROXY ACCESS

Brett H. McDonnell*

Recent developments in Delaware concerning shareholder bylaws and the new SEC rules concerning shareholder proxy access have (partly) moved the United States closer to a set of optimal rules for shareholder proxy access in nominating director candidates, but not all the way there. These rules must address both the default rule, which applies in the absence of agreement within a corporation to the contrary, and the altering rule, which specifies who within a corporation may choose to opt out of the default provisions. Applying principles of accountability and freedom of contract, the optimal default rule would allow for certain shareholders to use the corporate proxy to nominate director candidates. The optimal altering rule would make it easy for shareholders to propose bylaws under the Rule 14a-8 process to opt out of the default provisions. Although it would be desirable were states to set these rules on their own, a degree of managerialism at the state level combines with the history of extensive SEC regulation of the proxy process to give the SEC an important role in helping set the rules. Delaware is appropriately flexible but has the wrong default rule, while the SEC's new rules have the right default rule but too little flexibility.

I. INTRODUCTION

Shareholders are getting feisty. They are no longer content simply to abide by the “Wall Street rule.”¹ If they are unhappy with the performance of a company’s management, they do not simply sell their shares. Rather, they step in to try to change that management or to change some of the rules governing the corporation. This is not true for all shareholders, of course, but it is for an important and growing class of them. In recent years, the

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1. Under the Wall Street rule, dissatisfied shareholders simply sell their shares rather than engage in more costly efforts to complain or try to change behavior. See William W. Bratton & Michael L. Wachter, *Tracking Berle’s Footsteps: The Trail of The Modern Corporation’s Last Chapter*, 33 SEATTLE U. L. REV. 849, 864 (2010).

struggle of these activist shareholders to wrest some degree of power from corporate directors and officers has led to important developments in state corporate law and federal securities law.

Shareholders elect the board of directors. If they are unhappy with a company's performance, they can throw the bums out and replace them with someone better. That is the theory. In practice, for public corporations² without a controlling shareholder, the incumbent board controls the company's proxy material distributed to its shareholders.³ Boards could choose to allow challengers to their nominees to use the company's material, or they could choose not to do so. Guess what boards choose to do? Denied access to the corporate proxy, shareholders must either launch their own proxy solicitation or leave the field to the board's nominees. Proxy solicitations are generally too expensive for anyone except someone attempting to seize a controlling number of shares. So, board nominees are almost always left uncontested.

Frustrated with this situation, in recent years activist shareholders have attempted to rewrite the rules to allow their nominees to be included in corporate proxy materials, greatly lowering the costs of running a dissident slate. Sometimes they have tried to rewrite the rules in individual corporations.⁴ However, the only way for shareholders to do that on their own is by amending the corporation's bylaws.⁵ Recent state law developments have made this possible,⁶ but the federal rules governing the process of shareholder proposals have effectively blocked this route.⁷ In response, shareholders have tried to rewrite the rules for all public corporations at once. Knowing that most states, especially Delaware, are unlikely to adopt their agenda, they have turned to the SEC. The Commission has responded by rewriting the rules in this area.⁸

This article surveys the recent state and federal developments concerning proxy access as well as shareholder bylaw proposals concerning proxy access. I argue that Delaware and the SEC have moved closer to an optimal

2. Throughout this article I am concerned only with public corporations covered by the proxy rules of the federal securities laws.

3. In Delaware, DEL. CODE ANN. tit. 8, § 212 (West, Westlaw through 77 Laws 2010 2011), creates the power for proxy voting, while the power to decide what goes into a corporation's proxy material is part of the general broad grant of authority to the board under § 141(a).

4. See, e.g., *Am. Fed'n of State, Cnty. & Mun. Emps., Emps. Pension Plan v. Am. Int'l Grp.*, 462 F.3d 121, 123–24 (2d Cir. 2006).

5. Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 210 (2005) [hereinafter McDonnell, *Shareholder Bylaws*].

6. See *infra* Part IV.

7. See *infra* Part V.A.

8. See *infra* Part V.

set of rules. However, both state and federal law still have room for improvement.

To understand this area, we need to consider both the relevant default and altering rules, as these are shaped by both federal and state law. Default rules refer to the rules that apply to all corporations (of a relevant type) in the absence of an agreement to the contrary.⁹ Altering rules are the legal rules that define how a particular corporation can agree to be governed by provisions that differ from the default rule.¹⁰ Both state and federal law help define the current default and altering rules for proxy access, and a major point of contention in the current debate is the proper role of federal and state law in setting these rules.¹¹

Before the new SEC rules, the default rule for all but North Dakota corporations was that shareholders did not have access to the corporate proxy materials to make board nominations. How could corporations opt out of that situation? Boards can always include shareholder nominees under any circumstances they choose; almost universally, they choose not to. The only power under corporate law that shareholders have to initiate changes in corporate governance rules is through the bylaws. The scope of the shareholder bylaw power has been a matter of some mystery for years.¹² The Delaware Supreme Court recently started to delineate the scope of the bylaw power in *CA, Inc. v. AFSCME Employees Pension Plan*, concluding that shareholders may enact “procedural” bylaws.¹³ Unless carefully drafted, these bylaws may run afoul of the board’s fiduciary duty. Furthermore, it remains quite possible that boards can amend or repeal shareholder bylaws. From a shareholder perspective, these limits on the bylaw power are probably more annoyances than major roadblocks in the current altering rules. The real impediment is the SEC’s Rule 14a-8. This rule allows shareholders to use the corporate proxy to make a wide range of proposals, including proposed amendments to the bylaws.¹⁴ However, prior to the new SEC rules, Rule 14a-8 allowed boards to exclude from the proxy

9. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 87 (1989).

10. Ian Ayres, *Menus Matter*, 73 U. CHI. L. REV. 3, 6 (2006); Brett H. McDonnell, *Sticky Defaults and Altering Rules in Corporate Law*, 60 SMU L. REV. 383, 383, 385 n.6 (2007) [hereinafter McDonnell, *Sticky Defaults*].

11. See *infra* note 120 and accompanying text.

12. John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605, 605–07 (1997); Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TULANE L. REV. 409, 410–21 (1998); McDonnell, *Shareholder Bylaws*, *supra* note 5, at 207–09.

13. 953 A.2d 227, 234–36 (Del. 2008).

14. Shareholder Proposals, 17 C.F.R. § 240.14a-8 (2010).

proposals suggesting a bylaw that allowed shareholders access to the corporate proxy for nominating directors. By denying shareholders access for proposing proxy access, the SEC had effectively created an altering rule whereby it was prohibitively expensive for shareholders on their own to opt out of the no-proxy-access default rule.

The SEC's new rules set both the default and the altering rule. Rather than a no-proxy-access default, they create a complicated rule whereby shareholders holding enough shares can nominate a certain number of directors but not a majority.¹⁵ They do not allow corporations to opt out of this default rule in a way that restricts proxy access further than the new default, but they allow opting out in the direction of easier access.

I argue that this new situation is still not optimal, though it is an improvement. Two powerful values suggest shareholders should have a significant say in electing directors and setting corporate governance rules. One value is accountability. Directors and officers are supposed to act on behalf of shareholders but are in many ways tempted to act in their own interests. Many market mechanisms help counteract these temptations but quite imperfectly. The board election mechanism is one of the most fundamental forms of accountability, and proxy access simply works to make that mechanism more of a reality than a convenient fiction. If any form of increased accountability is defensible, this is it.

The other powerful value supporting change is freedom of contract. A key virtue of American corporate law is its flexibility—that is, it allows corporations to tailor rules to their own circumstances and preferences.¹⁶ Accordingly, most rules are default rules and corporations can opt out of these rules. This allows for experimentation, as we observe what rules work best in different corporations. It also allows for tailoring to the needs of differing corporations. A key question, that is under-analyzed, then becomes how easy we make it for corporations to opt out of these default rules. If we really value private ordering, we should make it easy for shareholders to opt out of the prevailing default rules if they so choose. The new system makes it easy for shareholders to opt for more generous proxy access rules, but they cannot choose more stringent rules.

15. Facilitating Shareholder Director Nominations, Securities Act Release No. 9,136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384, 75 Fed. Reg. 56,668, 56,675 (Aug. 25, 2010) [hereinafter Adopting Release] (to be codified at 17 C.F.R. § 240.14a-11).

16. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1–15 (1991); ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 48 (1993).

The optimal default rule would allow for proxy access under relatively generous conditions. Such proxy access would promote accountability while only very weakly limiting appropriate board authority. Boards can act much more cheaply and quickly than shareholders—after all, there are only about a dozen directors, and thousands of shareholders. Therefore, if a pro-shareholder default is inefficient, the board is likely to act quickly to change it, whereas if a pro-board default is inefficient, shareholders are much less likely to act to reverse it.¹⁷ A proxy access default rule also fits well with the role of corporate law as a transaction-cost minimizing set of defaults. Corporations that want to opt for no proxy access can easily structure such a rule on their own. However, a proxy access regime is somewhat complicated, involving choice over a number of dimensions—threshold shareholder level for nominating shareholders, time length those shares must have been held, how many directors shareholders may nominate, the disclosure required, and so on. A proxy access default regime can make these complicated decisions, avoiding the need for each corporation to do so. Even where a corporation may choose to opt out of the default regime on some dimensions, it may do so in only one or two ways with a short provision, trusting to the statutory default on other rules.

As for the optimal altering rule, it would allow shareholders (not boards) to opt out of the statutory default in any way that the shareholders choose. Boards could opt out in favor of a rule allowing shareholders greater access but not less access. The core value of freedom of contract supports this altering rule. Even if the relevant default rule-setter makes a good guess as to the optimal set of rules, it may well guess wrong. Even if it guesses well for the typical corporation, the default rules may not be best for all corporations, and individual tailoring may thus be called for.

Many similar arguments apply in considering both the default and the altering rule. Advocates of limited shareholder power tend to back both a default rule of no access and an altering rule in which shareholders alone cannot opt out of that default. Advocates of expansive shareholder power tend to back both a default rule of generous proxy access and an altering rule in which shareholders can at low cost enact bylaws which opt out of that default in any direction they please.¹⁸ This raises the question of whether any other mix of default and altering rules is internally consistent. This paper considers that question, concluding that other combinations are defensible but not easily so.

17. See *infra* notes 255–63 and accompanying text.

18. See *infra* notes 241–45 and accompanying text.

We also must consider the proper interplay of state and federal law in setting the default and altering rules for proxy access. In part this is because both levels of law are involved in setting these rules. More importantly, the appropriate mix of state and federal law is very much a part of the debate over the optimal rules in this area. A leading argument of opponents of the SEC's new rules is that the SEC is intervening in an area where state law is likely to lead to an optimal outcome.¹⁹

However, significant federal intervention in this area is justified. The two values of accountability and freedom of contract also play out in achieving a proper balance of federal and state rulemaking in this area.²⁰ We achieve freedom and flexibility by allowing corporations to choose whose state law will govern them. This carries some risk and the reality of a managerialist bent in state law (that is, state law goes too far in defending the interests of managers). To maintain adequate accountability, federal actors (the SEC, Congress, and federal courts) stand by to supplement or preempt state law when the states, especially Delaware, have gone too far in favoring managers over shareholders. In the case of proxy access, state law exhibits both its normal, desirable flexibility but also its tendency to be too managerial. In particular, the state law no-proxy-access default rule is hard to defend.²¹ Thus, some intervention from the SEC is appropriate. The SEC gets that intervention fairly right, but it is too rigid. The new default rule of proxy access under certain conditions is well justified. However, the rules should allow shareholders to opt out of this default in any way a majority of them choose.

In this article, my argument proceeds as follows. Part II provides some historical and legal background. Part III develops the basic policy arguments. Part IV surveys recent developments in Delaware, especially the *CA, Inc.* case. Part V explores recent developments at the federal level, particularly the new proxy access rules. Part VI sorts out where Delaware and the SEC have got it right, and where they have got it wrong. Delaware is appropriately flexible but has the wrong default rule; the SEC's new rules have the right default rule but too little flexibility.

19. See discussion *infra* Part V; see also note 8 and accompanying text.

20. Brett H. McDonnell, *Recent Skirmishes in the Battle Over Corporate Voting and Governance*, 2 J. BUS. & TECH. L. 349, 352–55 (2007) [hereinafter McDonnell, *Recent Skirmishes*]; Brett H. McDonnell, *Two Cheers for Corporate Law Federalism*, 30 J. CORP. L. 99, 100 (2004) [hereinafter McDonnell, *Two Cheers*].

21. See *infra* Part VI.A.

II. BACKGROUND

Shareholders elect directors—that is the rule for American corporations. For large public corporations with no controlling shareholder, most shareholders do not actually show up in person to vote for directors. Instead, if they vote at all, they do so by filling out proxy cards that appoint someone else as their proxy to go to the meeting and vote for them, with directions as to how to vote. State law creates the basic mechanics for the proxy system, but federal securities law heavily regulates proxy solicitations in public corporations. As a result of both the dispersed shareholder base of U.S. public corporations and the extensive federal regulation of proxy solicitations, it turns out to be extremely expensive to solicit proxies, often on the order of hundreds of thousands of dollars.²²

A. *The Default Rule*

As a result, most shareholders will not choose to engage in proxy solicitations on their own. This has proved crucial in the system of electing directors. State law generally gives shareholders power to nominate candidates for directors.²³ However, state law is silent²⁴ on the question of whether company proxy material must include shareholder nominees. Given that silence, nothing in state law forces boards to include shareholder nominees. Thus, the default state law rule is that boards are not required to do so; the decision of whether or not to include shareholder nominees in the corporate proxy falls into the great grant of discretionary power to boards.

Federal securities law was until very recently also silent on this point, despite extensive regulation of the proxy solicitation process. Proposals to require proxy access under some circumstances have been around for a long

22. Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 688–91 (2007).

23. The statutory basis for this power in Delaware is a bit murky, but Delaware courts have recognized its existence and importance:

[T]he unadorned right to cast a ballot in a contest for [corporate] office . . . is meaningless without the right to participate in selecting the contestants. As the nominating process circumscribes the range of choice to be made, it is a fundamental and outcome-determinative step in the election of officeholders. To allow for voting while maintaining a closed selection process thus renders the former an empty exercise.

Harrah's Entm't, Inc. v. JCC Holding Co., 802 A.2d 294, 311 (Del. Ch. 2002) (alteration in original) (quoting *Durkin v. Nat'l Bank of Olyphant*, 772 F.2d 55, 59 (3d Cir. 1985)); see also Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1263 (2009).

24. Except in North Dakota, see *infra* note 237 and accompanying text.

time. The SEC considered the issue as long ago as 1942.²⁵ Most recently, in 2003²⁶ and 2007²⁷ the SEC published proposed rule changes that would have allowed for proxy access under certain circumstances. In 2010, the SEC finally adopted new rules, although it then suspended those rules pending judicial resolution of a lawsuit challenging their validity.²⁸ The new rules make some degree of proxy access the default rule for all corporations subject to the SEC's proxy rules. The main conditions governing access under the new default rule are:

- The nominating shareholders must hold at least three percent of the outstanding shares;
- They must have held that amount of shares for at least three years; and
- Shareholders can use the proxy to nominate only up to one director or twenty-five percent of the board, whichever is greater.²⁹

The new rules are discussed more below in Part V.

B. *The Altering Rules*

1. State Law

Given the prior lack of proxy access as a default matter under both state and federal law, shareholders have attempted to change the rules within individual corporations. The lone way to do this, without board approval, is to amend the bylaws. This, in turn, raises issues under both state and federal law. Under state law, the question is how far the scope of the bylaw power extends. Under federal law, the question is whether shareholder bylaw proposals may be excluded under Rule 14a-8.

25. Securities Act Release No. 2,887, Exchange Act Release No. 3,347, Investment Company Act Release No. 417, 7 Fed. Reg. 10,653 *passim* (Dec. 18, 1942), available at 1942 WL 34864.

26. Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784, *passim* (Oct. 14, 2003).

27. Shareholder Proposals, Exchange Act Release No. 56,160, Investment Company Act Release No. 27,913, 72 Fed. Reg. 43,466, *passim* (July 27, 2007).

28. Adopting Release, *supra* note 15; Order Granting Stay, Securities Act Release No. 9,149, Exchange Act Release No. 63,031, Investment Company Act Release No. 29,456, 2010 SEC LEXIS 3275 *passim* (Oct. 4, 2010).

29. Adopting Release, *supra* note 15, at 56,675–76.

The question of how far the power of shareholders to enact bylaws extends has been gathering steam for the last decade.³⁰ One wonders why it has taken so long for the Delaware courts to actually confront the question. After all, for a very long time amending the bylaws has been the one general power that shareholders have. Shareholders, of course, have long had the right to vote for directors,³¹ but in public corporations that right has long been weak outside the context of a hostile takeover, as incumbent boards have dominated the mechanism for nominating and electing directors.³² Shareholders also have long had the right to vote on certain fundamental changes—certificate amendments,³³ mergers,³⁴ sales of substantially all assets,³⁵ dissolution³⁶—but in each case only if the board approved the change first. About the only thing that shareholders could do on their own without boards acting first was amending the bylaws.³⁷ If shareholders wanted to act to constrain boards, then, it would seem like the bylaws were an obvious place to look. If shareholders had been actively using the bylaw power before recently, then the Delaware courts would have had to decide how far that power extended long before now.

And yet that did not happen. *CA, Inc.* was only decided in 2008.³⁸ Before that decision there was some guidance in the case law as to the extent of shareholder power, but that guidance was fragmentary and limited. Why have courts only come to focus their attention on this question now?

Until recent decades, shareholders generally did not try to rally campaigns to influence boards. For one thing, boards did not really matter much. In the days of the managerialist firm,³⁹ the CEO was king, and the board was a council of advisors that got little attention from shareholders, executives, economists, legal scholars, or pretty much anyone. Why bother putting together an expensive campaign to influence such a trivial body? The legal reality was that the board was the locus of power to control the corporation, but the actual reality was quite different.

Moreover, shareholders relied on the Wall Street rule: if you were unhappy with a company's policies or behavior, do not buy its shares, or if

30. See Fairfax, *supra* note 23, at 1275–78.

31. See *supra* note 23 and accompanying text.

32. See Bebchuk, *supra* note 22, at 680–81.

33. DEL. CODE ANN. tit. 8, § 242 (West, Westlaw through 77 Laws 2010).

34. *Id.* § 251.

35. *Id.* § 271.

36. *Id.* § 275.

37. *Id.* § 109.

38. *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 227 (Del. 2008).

39. CHESTER I. BARNARD, *THE FUNCTIONS OF THE EXECUTIVE* (1938) is the classic book on managerialism, i.e., the dominance of corporations by their managers.

you have already done so, then sell them.⁴⁰ That was easier and cheaper than trying to solicit proxies in a campaign to unseat or constrain the board. Well-known collective action problems led to shareholder inaction.⁴¹ The hope and claim was that various mechanisms, including the Wall Street rule itself, would limit board and officer misbehavior.⁴²

Certain shareholders became more active in the seventies and eighties with the rise of hostile takeovers. A complex chess game between raiders and incumbent boards developed, and the Delaware courts stepped in repeatedly to define the rules of the game.⁴³ However, bylaws ultimately only played a relatively small role in that particular game, and then mostly in the form of board-enacted bylaws used as defensive measures.⁴⁴ In the great takeover wave of the eighties, then, we got little new guidance as to the extent of the power of shareholders to enact bylaws.

The hostile takeover wave gradually receded as boards figured out effective defense measures and state courts and legislatures allowed them to use those measures. A new sort of shareholder activism arose, tied to the rise of institutional investors. Certain public employee and union pension funds in particular began to use the Rule 14a-8 mechanism to make shareholder proposals at low cost.⁴⁵ At first, most of the proposals were merely advisory, as the SEC's rules encourage advisory proposals.⁴⁶ However, boards could simply ignore such proposals if passed by the shareholders. Shareholders faced with a recalcitrant board could not very well rely on advisory proposals as an effective stick. And so, shareholder activists turned to proposing amendments to the bylaws.

Shareholder bylaw proposals cover a wide range of topics. Perhaps the most important proposals in the first wave were poison pill bylaws. Taking a variety of forms, these poison pill bylaws attempted to limit the ability of boards to adopt or keep in place poison pills. The first major scholarly examinations of the shareholder bylaw power focused especially on poison pill bylaws.⁴⁷ The Oklahoma Supreme Court, applying statutory language

40. See *supra* note 1.

41. See *supra* Part I.

42. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 351–52 (1976).

43. See generally *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988) (discussing relevant Delaware precedent).

44. *Id.* at 652–57.

45. See Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1043–46 (1998).

46. 17 C.F.R. § 240.14a-8(i)(1) (2011) (see note to this paragraph).

47. See, e.g., John C. Coates IV & Bradley C. Faris, *Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives*, 56 BUS. LAW. 1323 (2001); Coffee, *supra* note 12; Jeffrey

very similar to that of the Delaware Code, found that such a poison pill bylaw was valid under Oklahoma law,⁴⁸ however, there was much doubt whether Delaware courts would follow this logic.⁴⁹

More recently, a major focus of shareholder bylaw proposals has been on the process of electing directors. Activist shareholders have proposed bylaws that would allow shareholders under certain circumstances to nominate directors using the corporate proxy (“proxy access proposals”),⁵⁰ bylaws that would require a majority vote to elect directors,⁵¹ and bylaws that would compensate shareholders for the expenses of a proxy contest if they succeed in electing a director.⁵²

These bylaw proposals raise complicated questions under both state and federal law. In the last few years, the Delaware courts, the Delaware legislature, federal courts, and the SEC have begun to consider these questions.

At the state level, the leading question is the scope of what bylaws can do. State law has a variety of specific provisions, but the general scope of valid bylaws is defined in a very murky way. In Delaware, there is a serious tension between section 109(b),⁵³ which seems to define a broad scope for the shareholder bylaw power, and section 141(a),⁵⁴ which sets a broad scope for the intrinsic power of boards. Although scholars have been discussing this tension for a while, the Delaware courts have largely avoided addressing the question until the *CA, Inc.* decision in 2008. Several recent statutory amendments also address the question.⁵⁵ Essentially, shareholders now (post-*CA, Inc.*) have the broad power to enact “procedural” bylaws, although they need to include fiduciary out provisions in those bylaws so that boards are not required by a bylaw to violate their fiduciary duty. A lesser, but still important, state law question is whether boards may amend or repeal shareholder-enacted bylaws. This question remains unanswered in Delaware, although a recent statutory amendment provides the answer for a

N. Gordon, “Just Say Never?” *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511 (1997); Hamermesh, *supra* note 12.

48. *Int’l Bhd. of Teamsters Gen. Fund v. Fleming Cos.*, 975 P.2d 907, 912–13 (Okla. 1999).

49. See Hamermesh, *supra* note 12, at 422–24.

50. The is the sort of bylaw at issue in *Am. Fed’n of State, Cnty. & Mun. Emps., Emps. Pension Plan v. Am. Int’l Grp., Inc.*, 462 F.3d 121, 122–23, 124 n.3 (2d Cir. 2006).

51. See William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 494–96 (2007).

52. The is the sort of bylaw at issue in *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 229–30 (Del. 2008).

53. DEL. CODE ANN. tit. 8, § 109(b) (West, Westlaw through 77 Laws 2010).

54. DEL. CODE ANN. tit. 8, § 141(a) (West, Westlaw through 77 Laws 2010).

55. See *infra* Part IV.D.

limited class of bylaws.⁵⁶ Part IV of this essay discusses these state law developments.

2. Federal Law

At the federal level, the main issue is what sorts of shareholder bylaw proposals may be excluded under Rule 14a-8. A shareholder who submits a proposal to the board is entitled to have that proposal submitted to a shareholder vote within the corporation's proxy material (saving the shareholder the huge costs of a separate proxy solicitation), as long as the shareholder conforms to a few non-strenuous procedural requirements.⁵⁷ However, the corporation may choose to exclude the shareholder proposal if that proposal falls within one of an enumerated category of excludable topics.⁵⁸

Several bases for exclusion are of particular relevance to our topic. One basis for exclusion is that the proposal is improper under state law.⁵⁹ This refers back to the state law controversy as to what bylaws are valid. Under a new procedure, the SEC can certify an uncertain state law question to the Delaware Supreme Court and have that court decide whether a proposed bylaw is valid under Delaware law.⁶⁰ That is how the *CA, Inc.* case was decided.⁶¹ A second basis for omission is if the proposal would violate a state, federal, or foreign law.⁶² As we shall see, this basis turned out to be important in the *CA, Inc.* case.⁶³ A third basis for excluding a proposal is if the proposal deals with "a matter relating to the company's ordinary business operations."⁶⁴

For shareholder access proposals, the biggest hurdle in Rule 14a-8 was, until very recently, the "relates to an election" basis for exclusion.⁶⁵ For many years the SEC interpreted this provision as allowing boards to exclude shareholder access proposals.⁶⁶ In 2006, the Second Circuit disputed that interpretation.⁶⁷ In response, the SEC considered two quite different

56. See *infra* notes 195–96 and accompanying text.

57. 17 C.F.R. § 240.14a-8(b)–(f) (2011).

58. *Id.* § 240.14a-8(i).

59. *Id.* § 240.14a-8(i)(1).

60. DEL. CONST. art. IV, § 11(8).

61. *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 299 & n.1 (Del. 2008).

62. 17 C.F.R. § 240.14a-8(i)(2).

63. See *infra* Part IV.C.

64. 17 C.F.R. § 240.14a-8(i)(7).

65. *Id.* § 240.14a-8(i)(8).

66. See *Am. Fed'n of State, Cnty. & Mun. Emps., Emps. Pension Plan v. Am. Int'l Grp., Inc.*, 462 F.3d 121, 128 (2d Cir. 2006).

67. *Id.* at 129–31.

potential changes to the language of the exclusion.⁶⁸ In the end, it adopted language that reinforced its old interpretation allowing for exclusion.⁶⁹ With new Commission appointees under the Obama administration, the SEC revised the relates to an election exclusion completely. Rule 14a-8 was amended to drastically narrow the exclusion. So now, bylaw proposals which would create a proxy access regime more generous than that under Rule 14a-11 are not excludable on this basis. But, shareholders are not allowed to enact bylaws which make proxy access available on more stingy terms than 14a-11.⁷⁰ Part V discusses these developments in detail. A major thesis of this article is that the revisions to Rule 14a-8 are an improvement to the status quo but that a better approach would allow shareholders more choice in deciding what proxy access regime should cover individual companies.

III. POLICY CONSIDERATIONS

We must consider both the desirable default rules and the desirable altering rules for shareholder voting for the board. The question as to the default rule is whether companies, in the absence of a company-specific rule to the contrary, should allow shareholders to nominate director candidates using the company's proxy material. The question as to the altering rule is how companies should be able to opt out of that default rule.

A. *The Default Rule*

There are a variety of approaches to deciding what default rules are optimal. The majoritarian approach asks what the shareholders in a majority of companies would choose if they could at no cost consider the matter and make a choice for themselves.⁷¹ Of course, it is easier to state that approach than to actually apply it in many concrete cases. Would shareholders in a majority of companies choose the prevailing default rule today, namely no proxy access?

I will consider that question in more detail in Part VI below. But first, consider the broad policy considerations in favor of and opposing a default

68. See generally Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56,161, 91 SEC Docket 575 (July 27, 2007); Shareholder Proposals, Exchange Act Release No. 56,160, 91 SEC Docket 544 (July 27, 2007).

69. Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56,914, 92 SEC Docket 256 (Dec. 6, 2007).

70. Adopting Release, *supra* note 15, at 56,669–77.

71. See Ayres & Gertner, *supra* note 9, 92–94.

rule that provides for some proxy access. The leading broad value favoring proxy access is accountability. At least since Berle and Means, the core problem of corporate law has been understood as how to discipline managers to act in the best interests of shareholders given the separation of ownership and control that occurs in public corporations with dispersed shareholdings.⁷² We understand managers as agents who are supposed to act in the best interests of their shareholders.⁷³ Shareholder voting for directors is one of the few direct accountability mechanisms that shareholders have to keep their agents in line. Lucian Bebchuk has made the compelling empirical and normative case that this mechanism is currently too weak and needs strengthening.⁷⁴ Currently, shareholders act as mere rubber stamps for unopposed board nominees. Proxy access is one of the best available ways to strengthen shareholder voting for directors.⁷⁵

Are there major countervailing policy considerations? Opponents of proxy access argue that it will result in high costs for several reasons. One problem is the out-of-pocket costs involved in responding to shareholder nominations.⁷⁶ However, these are not likely to be large relative to the existing costs of crafting a proxy statement disclosure.⁷⁷ Of more significance is the likely diversion of director and officer time and attention.⁷⁸ Nonetheless, unless one has good reason to distrust shareholder votes in contested elections, this diversion is likely to be significant only in cases where there is a real chance that board nominees will lose. These cases will only arise where the board is not performing well—thus, getting the attention of the directors in those cases is not such a bad thing.

Proxy access is likely to be unduly costly only if we think there is a high chance that shareholders will be at risk of getting their own best interests wrong in elections pitting board nominees against shareholder nominees. Why might that be so? It could happen either due to pervasive shareholder lack of information or because many shareholders are deliberately going against shareholder interests. There are well known reasons why shareholders are rationally ignorant about what goes on within public

72. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 112–18 (1932).

73. See Jensen & Meckling, *supra* note 42, at 309.

74. Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 850–61 (2005).

75. Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 330, 335–37 (2010).

76. *Id.*

77. Adopting Release, *supra* note 15, at 56,768–70.

78. *Id.* at 56,765.

corporations.⁷⁹ Still, shareholders should be aware of their own ignorance vis-à-vis the board, and hence be prone to defer to the board. And normally they do just that. The shareholders more likely to vote are institutional shareholders and they are more likely to be informed. Shareholders are likely to put aside their normal deference in cases where significant evidence suggests a board is not doing its job well—which is when we want shareholders to become more involved.

If simple shareholder ignorance, though common, is unlikely to lead to systematic anti-board bias when not appropriate, then some shareholders may be attempting to use proxy access deliberately to promote their own interests at the expense of other shareholders. A leading argument is that insidious special interest shareholders will usurp expanded shareholder power to their own nefarious ends. The main targets of this fear are union pension and public employee funds.⁸⁰ These are indeed typically the most activist of the institutional investors, although some hedge funds have become increasingly active as well.⁸¹ However, it is not clear that union and public employee funds operate against the interest of other shareholders. Their greater activism may be explained by the fact that they face less competition, and hence their managers are more willing to incur the costs of shareholder activism.⁸² A key limitation is that shareholder activists must achieve a majority vote of all shareholders to succeed. They are likely to succeed only if they are promoting a slate or position where their interests mesh with the interests of other shareholders.⁸³ Steve Bainbridge has presented some scenarios in which special interest shareholders might nonetheless be able to decrease shareholder value despite this majoritarian constraint.⁸⁴ My argument is that these scenarios are not plausibly of first-order importance.⁸⁵

Joseph Grundfest suggests a variant of this argument with his notion of “megaphone externalities.” The idea is that union and state pension fund managers can benefit from the publicity they will achieve by running board

79. EASTERBROOK & FISCHER, *supra* note 16, at 82–83.

80. Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 110 HARV. L. REV. 1735, 1751–57 (2006) [hereinafter Bainbridge, *Shareholder Disempowerment*]; Roberta Romano, *Public Pension Fund Activism in Corporate Governance*, 93 COLUM. L. REV. 795, 814–20 (1993).

81. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1029–30 (2007).

82. McDonnell, *Shareholder Bylaws*, *supra* note 5, at 243.

83. Bebchuk, *supra* note 74, at 885.

84. Bainbridge, *Shareholder Disempowerment*, *supra* note 80, at 1756–57.

85. Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of the New Corporate Governance in Theory and Practice*, 34 DEL. J. CORP. L. 139, 177–78 (2009) [hereinafter McDonnell, *Arrowian Moment*].

candidates even where their chances of success are slim.⁸⁶ There is presumably something to this, but I think there is not enough to present a strong argument against proxy access. Once the novelty has worn off, are shareholder activists really going to get that much press coverage when they run obviously quixotic campaigns for boards? If they have a real chance of success, coverage is more likely, but once again, those are the circumstances where we *want* incumbent boards to sweat. Moreover, shareholder activists can already use Rule 14a-8 proposals to draw attention to issues that concern them—why will the megaphone be much louder for board contests with little to no chance of success?

A broader argument against a strong shareholder power is that the board is the appropriate focus of authority in a corporation. It is clearly true that in a large public corporation with a dispersed shareholder base, informational considerations alone undoubtedly disable shareholders from making most operational decisions. The default rules of corporate law make obvious good sense in putting managerial decisions in the hands of the board (which can and does delegate most decisionmaking to the officers). Steve Bainbridge has constructed the most elaborate arguments in favor of strong limits on the ability of shareholders to be involved in running corporations.⁸⁷ Bainbridge draws heavily upon work by Kenneth Arrow⁸⁸ in arguing that accountability mechanisms go too far in undermining board authority.⁸⁹ Centralizing authority in a board avoids high costs involved in decisionmaking by poorly-informed, dispersed shareholders. Mechanisms which allow shareholders to second guess board decisions undo the gains of centralization by in effect eliminating board authority—if shareholders can second guess the board, then the board is not in fact the final decisionmaker.⁹⁰

However, I have shown in a prior article that Bainbridge's logic does not extend as far as he suggests.⁹¹ His argument is particularly weak against proxy access. Shareholder voting for directors is the most defensible form

86. Joseph Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUS. LAW. 361, 365 (2010).

87. See generally Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) [hereinafter Bainbridge, *Means and Ends*]; STEPHEN BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* (2008) [hereinafter BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE*].

88. See generally KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* (1974).

89. See, e.g., Bainbridge, *Means and Ends*, *supra* note 87; BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE*, *supra* note 87.

90. Bainbridge, *Shareholder Disempowerment*, *supra* note 80, at 1747 (quoting ARROW, *supra* note 88, at 78).

91. McDonnell, *Arrowian Moment*, *supra* note 85, at 162–85.

of accountability under his core Arrowian argument. That argument repeatedly stresses that accountability mechanisms should function only intermittently and not be used to review detailed ongoing decisions.⁹² Voting for directors operates precisely in that way. Voting is only on board nominees, not specific policy decisions, and it happens only once a year. Proxy access simply makes this limited form of accountability work as an actual measure of accountability, rather than a mere rubberstamp. If any sort of accountability measure is justified at all, this is.

There is an alternative approach to majoritarianism in defining optimal default rules within corporate law. Bebchuk and Hamdani suggest setting default rules in a way that favors shareholders. If that is indeed the optimal default for a particular corporation, it will remain. If not, it is easier for boards to opt out of a pro-shareholder rule than for shareholders to opt out of a pro-board rule. Thus, setting the default with a pro-shareholder rule is more likely to lead to an optimal final choice of rule.⁹³ This approach clearly favors a default rule that allows for some proxy access.⁹⁴

Perhaps the best argument against increased shareholder power (in either the default or the altering rule) flows from a stakeholder approach to the corporation. So far, I have assumed that corporations should be governed in the best interests of their shareholders. That is the dominant assumption in American corporate law and legal scholarship, but it is contested.⁹⁵ One might instead believe that the corporation should be run in the interests of a variety of constituencies, including at least creditors, employees, and shareholders.⁹⁶ In that case, shifting power to shareholders could be threatening to other constituencies. One might defend leaving boards strong at the expense of shareholders to protect other constituencies, with the board acting as a mediator which reflects the interests of several groups.⁹⁷

Here, we have a multi-party game with interactions between shareholders, creditors, employees, officers, and directors.⁹⁸ The question

92. *Id.* at 163–64.

93. Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 492 (2002).

94. Bebchuk & Hirst, *supra* note 75, at 350.

95. KENT GREENFIELD, *THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES* 16 (2006).

96. *Id.* I myself believe this. See Brett H. McDonnell, *Employee Primacy, or Economics Meets Civic Republicanism at Work*, 13 STAN. J.L. BUS. & FIN. 334, 341–42 (2008).

97. This is the core of the team production model of the firm. See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 280–81 (1999). See generally LAWRENCE E. MITCHELL, *CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT* (2001).

98. John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495, 1496 (1990).

is, are creditors and employees better off with a strong board looking after their interests? Or do they have enough shared interests with shareholders as against the board and officers that they would be better off if shareholders had expanded rights to hold the directors and officers more accountable? This is a tough question. On some matters, creditors and employees would appear to have interests aligned with shareholders, and on other matters not, and creditors and employees themselves may not always agree.

It is very hard to answer this question in the abstract, and it probably varies among corporations. As far as employees are concerned, it appears that the leading organized employee interest groups have opted in favor of espousing greater shareholder power.⁹⁹ Recall that union pension funds are among the leading shareholder activists. In the context of a shareholder primacy model,¹⁰⁰ this is problematic, since employees may have interests that differ from those of shareholders. It also gives rise to an argument against an expansive shareholder bylaw power, although we have seen that this argument is not conclusive.¹⁰¹ However, in the context of a stakeholder model¹⁰² in which representation of employee interests is a good thing, those union pension funds are a welcome sight. The unions seem to have decided that the tools of shareholder activism are a good way to advance their members' interests. That in turn suggests that we should not oppose increased shareholder power out of a concern for other corporate constituencies, at least not the employee constituency. A similar point applies to Grundfest's argument concerning megaphone externalities.¹⁰³

This stakeholder argument in favor of increased shareholder power may seem in some tension with my earlier argument that pension fund activists are not special interests going against the interests of other shareholders.¹⁰⁴ But the two arguments are consistent. Sometimes employee and shareholder interests will converge, and sometimes they will diverge. Given the distribution of shareholders in most public corporations, pension funds are likely to succeed in an initiative only when they can get the votes of many other shareholders. Thus, even if we believe that pension funds tend to think about the interests of labor as well as the value of their shares (and I suspect that is so), they are likely to pursue only those challenges to management where these two interests come together. From the point of view of

99. McDonnell, *Shareholder Bylaws*, *supra* note 5, at 250.

100. For the belief that corporations should serve shareholder interests, subject to ultimate shareholder authority, see Matthew T. Bodie, *AOL Time Warner and the False God of Shareholder Primacy*, 31 J. CORP. L. 975, 977–82 (2006).

101. See *supra* notes 80–85 and accompanying text.

102. See Bodie, *supra* note 100, at 977–82.

103. See *supra* note 86 and accompanying text.

104. See *supra* notes 80–85 and accompanying text.

shareholders generally, it is good to have such activists willing to challenge management, so long as other shareholders get to vote on what the activists propose. From the point of view of employees, although the pension fund activism route is severely limited by the need to concentrate only on issues where employee and shareholder interests converge, it is better than no power at all.

B. *The Altering Rule*

At issue in the ongoing legal developments surrounding proxy access is not just the appropriate default rule (should shareholders be able to put their nominees in the company's proxy statement?), but also the appropriate altering rule (should shareholders be able to change the default rule through a bylaw amendment?), and how easy should we make it for them to do that? Importantly, the valid scope of shareholder bylaws structures the "altering rules" of corporate law.¹⁰⁵ Most of state corporate law consists of default rules, which individual companies can alter to fit their own circumstances.¹⁰⁶ An important and under-studied topic is how the law structures the process for opting out of various default rules—the rules governing this process are corporate law's altering rules. How easy is it for a company to opt out, and who has the authority to do so?¹⁰⁷ If a company must opt out in the charter, that requires both shareholder and board approval, whereas opting out in the bylaws requires approval by only shareholders *or* the board.¹⁰⁸ An altering rule which allows for altering through the bylaws is easier—less sticky—than a rule which requires altering through the charter, and it also changes the authority structure, although in an ambiguous way because the shareholders and the board can each act on their own to amend the bylaws.¹⁰⁹

Two core guiding principles of American corporate law—accountability and freedom of contract—strongly favor un-sticky altering rules that give wide latitude to shareholders to set the basic rules of corporate governance within a company. We shall see that both of these principles justify a change from the status quo altering rule. However, they do not completely agree as to what that change should look like—this disagreement helps make sense of the competing considerations in the changes to Rule 14a-8.

105. McDonnell, *Sticky Defaults*, *supra* note 10, at 402–06.

106. See EASTERBROOK & FISCHER, *supra* note 16.

107. McDonnell, *Sticky Defaults*, *supra* note 10, at 402–06.

108. Compare DEL. CODE ANN. tit 8, § 109(a) (West 2010), with § 241(b) (West 2010).

109. Occasionally the law allows opting out only through a shareholder-enacted bylaw, not a board-enacted bylaw, but that is rare. See McDonnell, *Sticky Defaults*, *supra* note 10, at 405.

American state corporate law, and scholarship concerning that law, embodies a strong respect for freedom of contract. Companies have a wide range of choice in what rules they want to govern their internal relations. They can choose from a variety of forms of legal entities, given the choice of incorporation they can choose in which state to incorporate, and once they have chosen a state of incorporation they can tailor most legal provisions to suit their own circumstances. Most American corporate law scholars have defended this structure on the grounds that markets will operate to defend against most possible abuses of the corporate forms, so that rules and procedures which do not adequately protect shareholders will lose out in the competitive market.¹¹⁰ This type of argument mainly has been used to defend using default rather than mandatory rules, but the logic also favors altering rules that make change easy compared to sticky altering rules.¹¹¹

We have already considered the other major guiding principle favoring more shareholder power in setting rules through bylaws, namely the understanding of the relationship between shareholders and managers (officers and directors) as an agency relationship. Given that understanding, it makes obvious sense to argue that the principals should be able to structure basic governance relationships in a way that they believe will best induce their agents to act in their interests. This also supports the argument for some change in the status quo, so that shareholders are given more power to set the basic rules of the game through the bylaws and to effectively choose who will manage their companies.

Are there any valid counter-arguments favoring a limited shareholder bylaw power?¹¹² We have considered the argument that ignorant shareholders will make too many mistakes. We found this argument wanting with respect to voting on board nominees. Is the argument any more plausible when one comes to voting on the rules governing proxy access? That is an interesting question. One could argue it either way. Perhaps shareholders are better at making general corporate governance decisions like setting proxy access rules. This argument would be a defense of the widespread position adopted in response to the SEC's new rules, which argues that the default rule should be no proxy access, but that shareholders should be allowed to vote for bylaws granting more access.¹¹³ On the other hand, perhaps institutional activists are in a better position to

110. See generally EASTERBROOK & FISCHER, *supra* note 16; ROMANO, *supra* note 16.

111. McDonnell, *Sticky Defaults*, *supra* note 10, at 396–97.

112. For more extended discussion of the policy considerations surrounding the shareholder bylaw power, see McDonnell, *Shareholder Bylaws*, *supra* note 5, at 235–52.

113. See, e.g., Grundfest, *supra* note 86, at 362.

judge the abilities of persons they nominate to the board, and to evaluate the performance of an incumbent board, than they are to figure out the best proxy access rules for differing corporations. After all, state corporate law traditionally does give shareholders the power to vote on directors and very little else—perhaps that involves a recognition that this is the matter on which shareholders are best placed to vote on. To my knowledge, no one yet has made a good argument for shareholders being in a better position to make one of these kinds of decisions than the other. We also already have considered the argument that special interest shareholders will hijack measures increasing shareholder power and found it wanting.¹¹⁴

The more fundamental objection stems from Bainbridge's argument for director primacy.¹¹⁵ We have seen that Bainbridge's argument does not work against adjustments to the mechanism of board elections, but is it stronger as applied to bylaw amendments? No. Bainbridge's logic may support rules that ban shareholders from making ordinary business decisions, but it does not support rules that ban shareholders from setting rules that shape the structure of a company's governance and procedures.¹¹⁶ As we shall see, that distinction between business decisions versus governance and procedural rules tracks quite nicely the legal limits for the bylaw power.

Thus, the principle of contractual freedom and the goal of constraining director and officer misbehavior both favor an altering rule which allows shareholders to choose their preferred proxy access regime, and the latter also favors a default rule favoring proxy access in board elections. There are some counter-arguments, but in the end these central principles of corporate law do seem to point in the same direction.

The similarity in many of the arguments surrounding the optimal default rule and the optimal altering rule suggest a possible linkage. Many arguments against shareholder power, which I have considered, suggest both a default rule of no proxy access and an altering rule in which shareholders cannot act on their own to change that rule. And indeed, we do often find these positions linked. Bainbridge is perhaps the purest academic proponent of those positions, and corporate directors and officers and the interest groups that tend to side with them have traditionally argued for both positions (although as we shall see, in response to the SEC's 2009 proposal which led to the new rules,¹¹⁷ many of these groups have now given ground

114. See *supra* notes 80–85 and accompanying text.

115. See generally Bainbridge, *Means and Ends*, *supra* note 87.

116. McDonnell, *Arrowian Moment*, *supra* note 85, at 164–65.

117. Facilitating Shareholder Director Nominations, Securities Act Release No. 9,046, Exchange Act Release No. 60,089, Investment Company Act Release No. 28,765, 74 Fed. Reg.

on the altering rule, but that is probably a recognition of a changed political reality in which they need to compromise). Many arguments for shareholder power considered above suggest both a default rule of generous proxy access and an altering rule in which shareholders are able to set the rules themselves. Here too, we often find these positions linked. Bebchuk is probably the leading academic proponent, and shareholder activist groups have tended to take both positions as well (although where they seem on the verge of getting a favorable default rule, they do have some tendency to want to hard-wire that with an inflexible altering rule).

An interesting question then becomes whether there are plausible arguments favoring shareholder power in the default rule but not the altering rule or vice versa. As just noted, many defenders of board interests are now taking such a position, arguing for no access as the default rule but conceding that shareholders should be able to opt in to an access regime.¹¹⁸ I just suggested that current politics may explain that, but is there an intellectually consistent justification? Perhaps—the principle of freedom of contract supports a non-sticky altering rule, but has less bite in considering the default rule. Plus, perhaps shareholder ignorance is less pervasive in choosing a general governance rule than in choosing between individual director candidates. The opposite combination is also possible—the SEC adopted a pro-access default rule with a hardened altering rule (at least in one direction), and many shareholder advocates have embraced that rule.¹¹⁹ Perhaps this can be justified by a need to have minimal standards to protect shareholders, but going beyond this floor should be allowed. Alternatively, maybe shareholder ignorance is less pervasive in choosing between director candidates than in choosing a general governance rule. So, all sorts of combinations of default and altering rules can be argued for. Still, many of the arguments do tend to hang together, either favoring or opposing significant shareholder power in both the proxy access rule and in the altering rule.

C. *Federalism*

Part of strengthening the shareholder bylaw power includes applying Rule 14a-8 so that shareholders can use the Rule to propose bylaw changes. Even if shareholders have the power to enact a bylaw under state law, if they cannot use the corporate proxy materials to propose a bylaw, the costs

29,024 (June 10, 2009) [hereinafter 2009 Proposal] (to be codified at 17 C.F.R. pts. 200, 232, 240, 249 & 274).

118. See *infra* note 237 and accompanying text.

119. See *infra* note 238.

of engaging in their own proxy solicitation will usually make proposing a bylaw prohibitively expensive. In considering the effective altering rules for corporate law, one must look to Rule 14a-8—a federal rule—as well as to state law. Moreover, the SEC’s new Rule 14a-11 changes the default rule. A leading argument by opponents of Rule 14a-11 is that director elections are a traditional subject for state law and that state law leads to optimal rules on this matter.¹²⁰

Thus, the other important policy consideration that arises pervasively in this debate is federalism and the role of state and federal governmental actors in setting the relevant rules. There has been a long-running scholarly debate as to whether corporate law rules should be set at the state or federal levels. Advocates of the state level believe in a “race to the top,” where states compete to write rules that corporations and their shareholders find attractive.¹²¹ Advocates of the federal level believe in a “race to the bottom,” where states compete to offer management-friendly rules that do not adequately protect shareholders, at least with respect to some legal rules.¹²²

In prior writing, I have suggested an intermediate position. State-level rules offer benefits of flexibility, experimentation, responsiveness, and the creation of a highly expert and motivated body in the Delaware courts, leading to higher-quality law than a purely national-level system would produce. However, the dominant state (Delaware) also tends to be somewhat biased in favor of managers over shareholders, because the board plays the leading role in the choice of the state of incorporation. A mixed state-federal system—in which the states set basic rules, but federal actors sometimes intervene to set different rules where they think the state rules are inadequate—offers many of the advantages of both a purely state and a purely national system. Thus, the interaction between the state and federal levels is crucial.¹²³

120. See, e.g., Letter from James L. Holzman, Chair, Council of the Corp. Law Section, Del. State Bar Ass’n, to Elizabeth M. Murphy, Sec’y, SEC 5–6 (July 24, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-65.pdf>. This is apparently the first formal comment letter that section has submitted to the SEC. *Id.* at 2.

121. Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 227–30 (1985); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254–255 (1977).

122. See, e.g., Lucian Bebchuk, Alma Cohen & Allan Ferrell, *Does the Evidence Favor State Competition in Corporation Law?*, 90 CAL. L. REV. 1775 (2002); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

123. McDonnell, *Two Cheers*, *supra* note 20, at 138–40; McDonnell, *Recent Skirmishes*, *supra* note 20, at 352–54; Brett H. McDonnell, *Delaware, Federalism and the Expertise-Bias Tradeoff* (Law & Econ. Workshop, Berkeley Program in Law and Econ., Univ. of Cal. Berkeley, 2004), available at <http://escholarship.org/uc/item/8297d1rx?>.

Robert Ahdieh has also analyzed the state-federal interaction in this area in a way that gives much insight.¹²⁴ He calls for “dialectical regulation,” in which federal and state actors interact in a dynamic give and take as they develop corporate law.¹²⁵ Rule 14a-8 provides an especially good venue for such dialectical regulation. He calls for the SEC to give a greater role to state courts in deciding what shareholder proposals should be excludable. He sees the new Delaware procedure for certifying state law questions to the Delaware Supreme Court as showing particular promise.¹²⁶ As we shall see, this procedure gave rise to the crucial *CA, Inc.* case. Ahdieh argues that dialectical regulation would encourage innovation, provide better quality control over the production of legal rules, and allow for participation in rulemaking by a fuller range of interest groups.¹²⁷

Thus, there is an important role for the SEC and federal rules in the area of proxy access. Federal law has traditionally done more than state law to help ensure protection of shareholder interests in the area of shareholder voting,¹²⁸ perhaps in part because of the managerial bias of state law. As a result of this history, states are not expected to legislate in this area. Moreover, the costs imposed on shareholder activism by federal proxy rules are a major part of the reason that something like Rule 14a-8 is needed.¹²⁹ However, we should be wary of a complete federal takeover in this area that imposes a mandatory, uniform rule on all public corporations. Such a rule would cut off experimentation in an area where we really do not know for sure what the best rules look like.

We now turn from general policy considerations to a review and analysis of important recent state and federal developments in the area of shareholder bylaws and proxy access. These policy considerations will

124. Robert B. Ahdieh, *The Dialectical Regulation of Rule 14a-8: Intersystemic Governance in Corporate Law*, 2 J. BUS. & TECH. L. 165, 165, 169–68 (2007). See generally Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625 (2004); Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588 (2003); Robert B. Thompson, *Delaware, the Feds, and the Stock Exchanges: Challenges to the First State as First in Corporate Law*, 29 DEL. J. CORP. L. 779 (2004). Roe applies his influential model of Delaware-federal interaction to the proxy access debate in a new working paper. Mark J. Roe, *The Corporate Shareholder’s Vote and its Political Economy, in Delaware and in Washington* (February 14, 2011) (unpublished manuscript) (on file with the author).

125. Ahdieh, *supra* note 124, at 165, 169–84.

126. *Id.* at 175.

127. *Id.* at 181–83. But see Christopher M. Bruner, *Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate* 35–39 (Washington & Lee Legal Studies, Paper No. 2010-12, 2010), available at <http://www.ssrn.com/abstract=1669282> (arguing that the certification process has distorted the decisionmaking of the Delaware court by having it decide the issue before a bylaw is actually used in practice).

128. See Roe, *supra* note 124, at 612–14.

129. See *infra* note 260 and accompanying text.

guide our understanding of how effective those developments are likely to be.

IV. DEVELOPMENTS IN DELAWARE

Delaware is of course the leading American jurisdiction for public corporations. Thus, its rules for proxy access and the scope of valid bylaws are more important by far than the rules of any other state and quite possibly more important than the rules of all other states combined. Delaware courts consider dozens of corporate law cases every year; ultimately, every major state-corporate-law question will make it to Delaware. And yet, until very recently, there was little guidance as to the general scope of the shareholder bylaw power in Delaware.

A. *Default Rule*

Delaware law provides the basic mechanics for shareholder meetings, board elections, and the appointment of proxies to vote for absent shareholders.¹³⁰ Yet, it is largely silent on what companies must include in proxy solicitations that it chooses to distribute, in part due to the traditional dominance of the federal proxy rules in this area. Thus, nothing in Delaware law says that shareholder nominees must be included in the corporate proxy material. This silence has been, reasonably and rightly, interpreted to imply that the question of what to include in that material is subject to the sound discretion of the board under the vast grant of authority to the board under section 141(a).¹³¹ There has been no apparent movement to change this default rule in Delaware. This also appears to be the default rule in most other states, with North Dakota as an exception.¹³²

B. *Altering Rule*

There has been movement concerning the altering rule. Many provisions in Delaware's corporate law provide that specific rules can be set within a corporation's bylaws. For instance, the bylaws may set the size of the board of directors¹³³ or define the powers of officers.¹³⁴ For other sorts of rules,

130. DEL. CODE ANN. tit. 8, §§ 211–12 (West, Westlaw through 77 Laws 2010).

131. *Id.* § 141(a).

132. N.D. CENT. CODE ANN. § 10-35-08 (West, Westlaw through 2009 Regular Session) (granting right to proxy access to shareholders holding over five percent of outstanding shares).

133. DEL. CODE ANN. tit. 8, § 141(b) (West, Westlaw through 77 Laws 2010).

134. *Id.* § 142(a).

various specific provisions provide that the certificate of incorporation may set the rule for a corporation, without mentioning the bylaws.¹³⁵ A strong *expressio unius* argument implies that the bylaws may not be used to set such rules. For instance, only the certificate may provide for shareholder removal of directors on a classified board without cause¹³⁶ or specify the rights and powers of classes of shares.¹³⁷ For rules that are covered by such a specific statutory provision, it is clear whether a bylaw may or may not set the rule.¹³⁸

However, many important shareholder bylaws are not covered, or at least not clearly covered, by any such specific statutory provision. Proxy access bylaws were, until recently, an important example (we shall see that a new Delaware section does address, and validate, proxy access bylaws). Indeed, nothing in Delaware law, until recently, specifically spoke to the issue of proxy access. An important question thus becomes what Delaware law says about the validity of bylaws where there is no specific statutory provision on point.

There has been significant debate on this point in recent years. That debate has centered on two general statutory provisions. Section 109 is the basic provision providing for the existence of bylaws. Section 109(b) gives the general scope for bylaws:

The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.¹³⁹

This would seem to leave quite a broad residual scope for bylaws. But commentators and courts have pointed to a different statutory provision which limits this scope.¹⁴⁰ It is section 141(a), the core grant of authority to the board of directors:

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of

135. See McDonnell, *Shareholder Bylaws*, *supra* note 5, at 220–21.

136. DEL. CODE ANN. tit. 8, § 141(k)(1).

137. *Id.* § 151(a).

138. For a relatively comprehensive list of such specific statutory provisions in Delaware, see McDonnell, *Sticky Defaults*, *supra* note 10, at 437–39.

139. DEL. CODE ANN. tit. 8, § 109(b) (West, Westlaw through 77 Laws 2010).

140. See *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 232 (Del. 2008); Hamermesh, *supra* note 12, at 428–34.

directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.¹⁴¹

Insofar as a bylaw operates to limit the discretion of the board (and what bylaw does not?), it potentially runs afoul of section 141(a).

As I have noted before, there are three basic ways to attempt to reconcile these three provisions:

First, section 109(b) does not on its own validate any sort of bylaw provision, because section 141(a) always trumps it. Second, section 141(a) does not provide any sort of limitation whatsoever on the provisions that section 109(b) allows, because section 109(b) always trumps 141(a). Third, one can split the difference so that section 109(b) does allow for some limitations on matters that otherwise would be subject to board authority, but section 141(a) limits how far such bylaw provisions can go. The question then arises as to how to split the difference.¹⁴²

Until 2008, no Delaware case ruled definitively on these competing interpretations. Scholars took varying positions, as scholars are wont to do. In probably the leading article, Larry Hamermesh took a position quite close to the first above, that section 141(a) always trumps.¹⁴³ In his current work in progress, Gordon Smith argues that the second position should triumph, namely section 109(b) should always trump.¹⁴⁴ John Coffee staked out the third position, suggesting four possible distinctions to help split the difference:

- Bylaws can regulate fundamental but not ordinary matters;
- Bylaws can act as negative constraints but may not affirmatively order the board to take actions;
- Bylaws can regulate procedure but not substance; and
- Bylaws can regulate corporate governance but not business decisions.¹⁴⁵

In my original piece on bylaws, I used detailed arguments based on statutory text, legislative history, case law, and policy to defend the split-the-difference position, with the last two of Coffee's distinctions providing

141. DEL. CODE ANN. tit. 8, § 141(a) (Westlaw).

142. McDonnell, *Shareholder Bylaws*, *supra* note 5, at 214.

143. Hamermesh, *supra* note 12, at 428–34.

144. D. Gordon Smith, Matthew G. Wright & Marcus Kai Hintze, Private Ordering with Shareholder Bylaws 9–14 (Mar. 26, 2011) (unpublished article), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1797066.

145. Coffee, *supra* note 12, at 613–14.

guidance as to how to split the difference.¹⁴⁶ In brief, a split-the-difference approach gives some effect to all relevant language in both sections 141(a) and 109(b), whereas the other two approaches must ignore some parts of the statutes. As a matter of policy, an approach that subordinates 109(b) to 141(a) fails under considerations of both accountability and flexibility. As for accountability, bylaws are the only way that shareholders can shape governance mechanisms without gaining board approval. As for flexibility, allowing shareholders to act without board approval allows for easier adaptations to new or differing circumstances. On the other hand, an overly broad shareholder power which gives shareholders unlimited power to encroach upon operational decisions would go too far in contradicting the core grant of authority to boards that is a central part of corporate law.

C. *Altering Rule—CA, Inc.*

Until 2008, there was only fleeting analysis of this problem in Delaware case law.¹⁴⁷ That changed with the Delaware Supreme Court's decision in *CA, Inc. v. AFSCME*.¹⁴⁸ The case arose through an important new procedure that increases the chances for useful dialogue between the SEC and the Delaware Supreme Court.¹⁴⁹ The AFSCME Employees Pension Plan submitted a bylaw proposal under Rule 14a-8 to CA, Inc. The bylaw would have required the corporation to reimburse shareholders for reasonable expenses incurred in a successful proxy contest for board seats under certain circumstances. Because such proposals are not excludable under the "relates to an election" basis for exclusion,¹⁵⁰ the issue boiled down to whether the bylaw was a proper subject for shareholder action under state law or otherwise violated Delaware law, the first two bases for exclusion in Rule 14a-8.¹⁵¹

In the past, the SEC would have either analyzed the state law question itself or else said it would not take a position on the state law question and hence would not take a position on whether the proposal was excludable.¹⁵² A new procedure in Delaware, however, allows the SEC to certify state law questions such as these to the Delaware Supreme Court, which has

146. McDonnell, *Shareholder Bylaws*, *supra* note 5, at 216–23.

147. For analysis of that case law, see *id.* at 230–35.

148. *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227 (Del. 2008).

149. See Ahdieh, *supra* note 124, at 171–74.

150. Shareholder Proposals, Exchange Act Release No. 56,160, Investment Company Act Release No. 27,913, 72 Fed. Reg. 43,466, 43,469 (July 27, 2007) (to be codified at 17 C.F.R. pt. 240).

151. See 17 C.F.R. § 240.14a-8(i)(1), (2) (2010).

152. See Bruner, *supra* note 127, at 30–31.

discretion whether or not to accept and decide the question.¹⁵³ This was the first time the SEC certified a question to the Delaware court, and the court accepted it.¹⁵⁴

The court answered the two questions certified to it by the SEC separately. It first analyzed whether the proposed bylaw was a proper subject for shareholder action under Delaware law.¹⁵⁵ This is where the court, for the first time, gave a general answer to the tension between sections 109(b) and 141(a) described above. The court first laid out the statutory conundrum.¹⁵⁶ It then rejected CA's argument that any bylaw which might in any way limit board power is not allowed under section 141(a), i.e., it rejected the first possible position described above, that section 141(a) always trumps section 109(b).¹⁵⁷ It noted that otherwise shareholders could not adopt any bylaws, because all bylaws can be characterized as in some way restricting board authority.¹⁵⁸

The court then looked to specific statutes and case law in an attempt to characterize what bylaws typically do.¹⁵⁹ It reasoned that "[i]t is well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made."¹⁶⁰ Thus, the court accepted as critical the procedure/substance distinction noted above as one of four possible ways one might distinguish valid from invalid bylaws.

How far does this go in answering the question of what bylaws are valid? It helps a lot. But one must note two important limits on the guidance provided. First, the court says that setting procedure is "*a* proper function" of bylaws (emphasis added). This leaves open the possibility that there may be other proper functions. The court specifically emphasized that it was not attempting to adopt with "doctrinal exactitude a bright line that divides those bylaws that shareholders may unilaterally adopt under Section 109(b) from those which they may not under Section 141(a)."¹⁶¹ Thus, it remains possible that Delaware courts may use one or more of the other three distinctions described above in deciding cases where the procedure/substance distinction does not give a clear or satisfactory answer.

153. DEL. CONST. art. IV, § 11(8) (West, Westlaw through 77 Laws 2010).

154. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 229 n.1 (Del. 2008).

155. *Id.* at 231–37.

156. *Id.* at 232.

157. *Id.* at 234.

158. *Id.*

159. *Id.* at 234–35.

160. *Id.*

161. *Id.* at 234.

Second, as the court noted, the procedure/substance distinction is not an incredibly sharp bright line rule. Many matters will fall clearly on one or the other side of that line, but for many other matters how to apply this distinction will be reasonably disputed. Indeed, for the proxy expense reimbursement bylaw at question in the case itself, it was not utterly clear on which side of the line it fell. CA argued that because the bylaw ordered the expenditure of corporate funds in specified circumstances, it was substantive not procedural.¹⁶² The court did not find this point dispositive.¹⁶³ Instead, it characterized this bylaw (quite plausibly) as being about the process for electing directors, which is “a subject in which shareholders of Delaware corporations have a legitimate and protected interest.”¹⁶⁴ Thus, it held that this bylaw was procedural and hence a valid subject for shareholder action under Delaware law.¹⁶⁵

How might this rule be applied for other bylaws? Consider a few other types of bylaws that are of current interest:

- Proxy access bylaws would clearly count as procedural because they too are about the process for electing directors.
- Bylaws requiring a binding or non-binding shareholder vote for setting director or officer compensation would seem valid because they regulate the procedure for setting compensation.
- Bylaws setting limits on director or officer compensation look less procedural. However, they may be valid as setting rules of corporate governance or may be valid under specific statutory provisions, such as section 141(h) for director compensation¹⁶⁶ or section 142 for officers.¹⁶⁷
- Bylaws splitting the positions of board chair and CEO may or may not be procedural, and may also be justified either as setting corporate governance rules or by more specific statutory provisions such as section 142.¹⁶⁸

162. *Id.* at 236.

163. *Id.*

164. *Id.* at 237.

165. *Id.*

166. DEL. CODE ANN. tit. 8, § 141(h) (West, Westlaw through 77 Laws 2010).

167. *Id.* § 142.

168. *Id.*

- Bylaws limiting the ability of boards to adopt or use poison pills may be valid or not depending on exactly how they are drafted.¹⁶⁹

Unfortunately for AFSCME, the court did not stop its analysis with the conclusion that the reimbursement bylaw was a valid subject for shareholder action. It went on to ask, in the highly unsatisfactory legal analysis of Section IV of its opinion, whether the bylaw might otherwise violate Delaware law.¹⁷⁰ The court began this section by noting that it confronted the bylaw before it had even been passed, not in litigation over the application of the bylaw in particular circumstances.¹⁷¹ It thus construed its duty as asking whether there was “any possible circumstance”¹⁷² under which the bylaw might cause a violation of Delaware law. This is a very harsh sort of facial validity analysis, and probably an unintended consequence of the functioning of the new certification procedure. The court need not have interpreted its question in this way; for instance, it could have done what courts do in examining the facial constitutionality of a statute. In that analysis, a statute’s “overbreadth . . . must not only be real, but substantial as well, judged in relation to the statute’s plainly legitimate sweep.”¹⁷³ Such an approach would seem more in line with the traditional presumption of validity that the courts extend to bylaws.¹⁷⁴ Christopher Bruner argues that even under such an approach the court would probably have still held the bylaw invalid.¹⁷⁵ Perhaps, but I find it quite a stretch to say there’s really a broad range of circumstances in which a board’s duty would *require* it to not compensate successful shareholder nominees. That said, I do agree with Bruner that given the approach the Delaware courts have chosen to take in *CA, Inc.*, it would be better for the SEC to not certify issues to Delaware and instead simply refuse to issue a letter saying it will take no action on the basis of the state law exclusion where there is significant doubt as to the application of the state law.¹⁷⁶

169. I analyze these sorts of bylaws in more detail in McDonnell, *Shareholder Bylaws, supra* note 5. Matthew F. Sullivan, *Shareholder Bylaw Proposals, Delaware Certification, and the SEC After CA, Inc. v. AFSCME Employees Pension Plan*, 87 U. DET. MERCY L. REV. 193, 213–15 (2010), argues that most bylaws outside of the director election context will be held invalid under *CA, Inc.* However, Sullivan does not analyze specific types of bylaws, and note that bylaws are used widely outside of the context of setting rules for elections, e.g. in setting the existence and duties of corporate officers.

170. *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 238–40 (Del. 2008).

171. *Id.* at 238.

172. *Id.*

173. *Broadrick v. Oklahoma*, 413 U.S. 601, 615 (1973).

174. *CA, Inc.*, 953 A.2d at 238.

175. Bruner, *supra* note 127, at 35–36.

176. *Id.*

What other law might such a bylaw violate? The court looked to the fiduciary duty that the common law imposed upon boards.¹⁷⁷ It asked whether there might be some circumstances under which the reimbursement bylaw would force directors to violate their duties to the corporation.¹⁷⁸ It found that there are such circumstances.¹⁷⁹ For instance, if shareholders engaged in a proxy contest were “motivated by personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation, the board’s fiduciary duty could compel that reimbursement be denied altogether.”¹⁸⁰

The court reached this conclusion by analogizing to cases where board-approved merger contracts or rights plans might force violations of fiduciary duties.¹⁸¹ An obvious response is that matters are different where shareholders impose limitations on the board rather than the board limiting itself. Because, after all, the point of fiduciary duty is to protect shareholders. One might very well think that if the shareholders themselves have decided to limit board discretion, then it is no violation of fiduciary duty for the board to abide by such shareholder-imposed limits.

The court calls this a “distinction . . . without a difference”¹⁸² and a response that “is more semantical than substantive.”¹⁸³ These characterizations are rather stupefying, frankly, and do not live up to the normally high standards of reasoning in Delaware decisions. The core point of fiduciary duty is to provide some court scrutiny of board actions that may harm shareholders. Boards have widespread power to act on behalf of shareholders, and neither shareholder-imposed limits nor statutory limits can fully anticipate all the ways in which boards might abuse their power. Thus, the standards-based approach of fiduciary rules provides a more nuanced, contextual approach to limiting board misbehavior.¹⁸⁴ However, if shareholders have considered a general class of actions and decided to limit board behavior in a specified way, then that would seem to decide the matter for that behavior—the board cannot do it if shareholders have said they cannot (assuming shareholders have the power to set the rule in question, as the court decided they did in this case). The point is not that shareholders will always set the rules optimally in their own best interests—they will get things wrong sometimes. But, if the shareholders have set a

177. *CA, Inc.*, 953 A.2d at 238–39.

178. *Id.* at 238.

179. *Id.* at 238–39.

180. *Id.* at 240.

181. *Id.*

182. *Id.* at 239.

183. *Id.*

184. See EASTERBROOK & FISCHER, *supra* note 16, at 90–93.

rule that it is within their power to set, then the board's fiduciary duty comes to an end on that matter. The potential for misbehavior where *boards* limit future board behavior is utterly different from situations where *shareholders* limit future board behavior. Perhaps the court can defend its result, but not by saying that there is no difference between the two situations. How the court could label this distinction as merely "semantical" is quite beyond me. Had students written that analysis on one of my exams, they would not have fared well.¹⁸⁵

At first blush, the consequences of this part of the *CA, Inc.* decision are quite far-reaching. After all, with practically any bylaw it is possible to imagine some circumstances under which the board might be forced to do something which its fiduciary duty would otherwise forbid it from doing. Thus, it would seem that virtually any bylaw would violate the law if subjected to the case's style of facial analysis. However, two important caveats limit the sweep of that analysis.

First, this analysis occurs in the context of a bylaw whose validity as a subject for shareholder action comes from the general grant of authority under section 109(b) rather than from a more specific statutory grant of authority. Conceivably, the court's analysis might differ for bylaws based on a more specific grant of authority.¹⁸⁶ Nowhere does the court explicitly raise this possibility, and it may well be that the court would analyze bylaws based on a specific grant of authority in the same way. It does seem that in its analysis of whether the bylaw would force a violation of fiduciary duty, the court was, in an odd way, re-visiting its discussion of the split of authority between shareholders and boards that it had analyzed in the previous section, and deciding that point in a way that was not really consistent with its earlier analysis. Perhaps for a point of law in which statutes have specifically granted authority to shareholders to set the rules, the court would not interpret the common law fiduciary duty in such a broad way. In a sense, this is an application of the rule that specific legal provisions govern more general ones where the two conflict.

185. This analysis assumes that fiduciary duties are indeed for the benefit of shareholders, the prevailing assumption in most scholarly analysis of Delaware corporate law. Christopher Bruner points out that if one sees Delaware law as more ambiguous than that, the decision may make more sense as a way for the courts to retain more discretion in drawing the line between board and shareholder power. Christopher M. Bruner, *Shareholder Bylaws and the Delaware Corporation*, 11 *TRANSACTIONS: TENN. J. BUS. L.* 67, 73 (2009).

186. If that is so, then the bylaw in question in *CA, Inc.* itself would now be valid, given modifications to Delaware law. See *infra* note 191 and accompanying text.

Second, shareholders can protect a bylaw from the court's analysis by including a "fiduciary duty out" clause.¹⁸⁷ These are common in merger no-shop provisions. In those provisions, a merger contract may provide that the seller cannot shop itself to other buyers. This limitation may violate fiduciary duty under Delaware law. A fiduciary duty out provides that where the limitation does violate fiduciary duty, the no-shop provision does not apply. Such fiduciary duty outs may save no-shop provisions that would otherwise be invalid.¹⁸⁸ Although the court in *CA, Inc.* does not explicitly consider the possibility of such a fiduciary duty out, because it analogizes the reimbursement bylaw to no-shop provisions, presumably the fiduciary duty outs that can save the latter should also be able to save the former.

How much of a limitation on the effectiveness of shareholder bylaws would such fiduciary duty outs be? Would boards regularly exercise them to ignore what a shareholder-enacted bylaw requires them to do? I doubt it, for two reasons. First, exercising such a fiduciary duty out would be a blatant slap in the face of shareholders. After all, a majority of shareholders will have approved the bylaw in question. To exercise the out, the board will have to argue that despite the shareholders' action, in the case in question shareholders are acting so improperly that the board's fiduciary duty compels it to ignore the stated preference of a majority of shareholders. I doubt directors will want to do that very often, although only time will tell.

Second, where a board does exercise a fiduciary duty out, I would expect the affected shareholders to challenge that action in court. For bylaws regulating shareholder elections (the sort we are primarily concerned with in this article), it will often be possible for the shareholders to plausibly characterize the board's action as intended to limit the exercise of the shareholder voting franchise. If the court accepts that characterization, the stringent *Blasius* standard of review will apply,¹⁸⁹ and the board will almost certainly be unable to justify its action. Even where the court does not apply *Blasius*, I would expect a somewhat skeptical review of board claims that "my fiduciary duty made me do it." Skepticism would certainly be justified.

Thus, although on its face *CA, Inc.* might appear to be a loss for shareholders, in fact it is largely a win. The Delaware Supreme Court has now held that shareholders have broad power to enact procedural bylaws.

187. Christopher Fawal, *Protecting Shareholder Access to Director Elections: A Response to CA, Inc. v. AFSCME Urging the Adoption of a Blasius Standard of Review for the Exercise of a Fiduciary-Out Clause*, 59 DUKE L.J. 1457, 1478–83 (2010).

188. See William T. Allen, *Understanding Fiduciary Outs: The What and the Why of an Anomalous Concept*, 55 BUS. LAW. 653, 653–54 (2000).

189. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 660–62 (Del. Ch. 1988); see Fawal, *supra* note 187.

That power should be enough to enact most of what shareholders should legitimately wish to enact. The requirement of including a fiduciary duty out is annoying, but hopefully not much worse than that.

D. Post-CA Developments

Two changes to the Delaware General Corporation Law in the wake of *CA, Inc.* further reinforce the power of shareholders to enact bylaws regulating board elections. New section 113 explicitly legitimizes reimbursement bylaws of the sort at stake in *CA, Inc.* Section 113 provides that “[t]he bylaws may provide for the reimbursement by the corporation of expenses incurred by a stockholder in soliciting proxies in connection with an election of directors, subject to such procedures or conditions as the bylaws may prescribe.”¹⁹⁰

Section 112 explicitly legitimizes proxy access bylaws stating that “[t]he bylaws may provide that if the corporation solicits proxies with respect to an election of directors, it may be required, to the extent and subject to such procedures or conditions as may be provided in the bylaws, to include in its proxy solicitation materials (including any form of proxy it distributes), in addition to individuals nominated by the board of directors, 1 or more individuals nominated by a stockholder.”¹⁹¹ Such bylaws were very likely valid under the logic of *CA, Inc.*, but now their validity is even more clear. Note that the default rule, absent such a bylaw or board action, remains a no-proxy-access rule. It appears that Delaware has now done what it is willing to do in this area with these amendments. It acted by clarifying that its altering rule gives shareholders the power to set bylaws in this area. It did not show any interest in changing the default rule of no proxy access. It appears unlikely to do so anytime soon.¹⁹²

Do these new statutory provisions have any effect beyond acknowledging and entrenching what was already definitely or likely true given the result in *CA, Inc.*? That depends on how one resolves the ambiguity in the case discussed above. Remember my suggestion that the fiduciary duty analysis in the final section of the case conceivably might not apply for a bylaw based on a more specific statutory grant of power than

190. DEL. CODE ANN. tit. 8, § 113 (West, Westlaw through 77 Laws 2010).

191. *Id.* § 112.

192. The Committee on Corporate Law of the American Bar Association has adopted similar rules for the Model Business Corporation Act. *See Corporate Laws Committee Adopts New Model Business Corporation Act Amendments to Provide for Proxy Access and Expense Reimbursement*, A.B.A. (Dec. 17, 2009), http://www.abanet.org/abanet/media/release/news_release.cfm?releaseid=848.

section 109(b). If so, then bylaws covered by sections 112 and 113 do not require fiduciary duty outs. I would not suggest that shareholders trust in that possibility, however, unless they want to test the logic.

Thus, shareholders have a fairly broad power to enact procedural bylaws under Delaware state law (and I suspect the laws of other states as well). The exact contours of “procedural” bylaws remain murky, but bylaws regulating elements of corporate electoral contests appear quite likely to be held valid, although they will probably need to include fiduciary duty outs.

E. Boards Amending Shareholder Bylaws

One other related state law question remains quite unclear in Delaware. Once shareholders succeed in enacting a bylaw, to what extent if any may the board amend or eliminate that bylaw through its own subsequent bylaw amendment?¹⁹³ In states which follow the Model Business Corporation Act, the answer to this question is clear: the board cannot amend or repeal a shareholder-enacted bylaw if that bylaw expressly so provides.¹⁹⁴

However, in Delaware the statutes are completely silent on this point, with one exception. Under that exception, “[a] bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors.”¹⁹⁵ It might seem by negative implication that the board may amend or repeal other shareholder bylaws. But the legislative history of this provision, adopted recently in 2006, specifically rules out this negative implication.¹⁹⁶

Thus, for all other sorts of shareholder amendments, we do not know whether boards may amend or repeal shareholder bylaws. To my knowledge, two Delaware cases addressed this point in dicta. One says the board can amend shareholder bylaws,¹⁹⁷ and the other says the board cannot.¹⁹⁸ The leading scholarly treatment argues the board can.¹⁹⁹ But note:

193. This assumes that the certificate grants the board the power to amend the bylaws, a nearly if not completely universal provision, and that nothing in the certificate limits the ability of the board to amend shareholder-enacted bylaws.

194. MODEL BUS. CORP. ACT § 10.20(b)(2) (2007).

195. DEL. CODE ANN. tit. 8, § 216 (West, Westlaw through 77 Laws 2010).

196. “This amendment does not address any other situation in which the board of directors amends a bylaw adopted by a stockholder vote.” 2006 Del. Legis. Serv. ch. 306 synopsis (West).

197. Centaur Partners, IV v. Nat’l Intergroup, Inc., 582 A.2d 923, 929 (Del. 1990).

198. Am. Int’l Rent A Car, Inc. v. Cross, No. 7583, 1984 Del. Ch. LEXIS 413, at *8–9 (Del. Ch. May 9, 1984).

199. Hamermesh, *supra* note 12, at 467–75.

that treatment did not turn out to be correct in predicting the scope of valid shareholder bylaws, advocating a more limited scope than the court adopted in *CA, Inc.*

This question is at least potentially of great practical importance. Boards can act much more quickly and easily than shareholders in public corporations, since there are several orders of magnitude more shareholders than directors. If boards can legally amend or repeal shareholder bylaws, then as soon as shareholders succeed in passing a bylaw the directors do not like, boards would have the power to immediately eliminate or amend those bylaws. However, this threat may not be as bad as it looks. First, shareholders could enact procedural limits (in the bylaws) to make it harder for boards to repeal shareholder bylaws. Second, I would guess that boards would be reluctant to act so blatantly against shareholder-enacted rules. As with the exercise of fiduciary duty outs, it strikes me as a rather desperate act that boards would resort to only *in extremis*.

In sum, these recent developments represent rather typical behavior for Delaware. Maintaining Delaware's place as the leading haven for incorporation creates some bias against expanding shareholder power at the cost of board power. Yet the value of experimentation and tailoring, and freedom of contract more generally, make a significant shareholder bylaw power one area where Delaware is willing to expand shareholder power somewhat. Moreover, this expansion takes place in a context of increased federal attention to this area, so that Delaware probably feels a need to be seen as acting in order to fend off more drastic federal action. And yet, Delaware is not willing to go so far as to create a pro-proxy access default rule.

V. DEVELOPMENTS AT THE FEDERAL LEVEL

And so, Delaware state law is now fairly hospitable for shareholder initiatives supporting proxy access and other issues. The default rule remains no proxy access. However, shareholders have the power to enact bylaws providing for proxy access, although they may need to provide for a fiduciary duty out and a threat of board repeal or amendment remains. The situation is broadly similar in other states. I am aware of no states other than North Dakota which provide for some proxy access as a default rule.²⁰⁰ The general scope of the bylaw power in other states is less clear—the statutory language is similar,²⁰¹ but other states do not have a case like *CA, Inc.*

200. See *supra* note 132.

201. MODEL BUS. CORP. ACT § 2.06 (2007).

clarifying this language. In many other states it is clear that boards may not amend shareholder bylaws that provide they may not be amended.²⁰²

A. *The Rule 14a-8 Framework*

Overall, this is not enough for proxy access bylaws to become a widespread phenomenon. The same collective action problems that make proxy access crucial for shareholder nominations recur at the level of proposing proxy access bylaws. Shareholders can engage in their own proxy solicitation to pass a proxy access bylaw, but this is prohibitively expensive.²⁰³ The obvious alternative is for shareholders to have their proxy access bylaws included within the corporate proxy material under the Rule 14a-8 process.

However, boards will try to exclude those bylaw proposals. Four possible bases of exclusion are of the most general importance for proxy access bylaws.²⁰⁴ We have already encountered the first two. One possibility until recently was to argue that the proposal is not a valid subject for shareholder action.²⁰⁵ After *CA, Inc.* and the addition of section 112, this argument is a loser for proxy access bylaws in Delaware corporations, although for companies incorporated elsewhere this argument remains available. A second possible basis for exclusion is that the proposal otherwise violates state law²⁰⁶ by forcing boards to violate their fiduciary duty. As we have seen, this argument prevailed in *CA, Inc.*, but can be blocked if the proposed bylaw contains a fiduciary duty out. Whether other states will accept the strained reasoning in this part of *CA, Inc.* remains to be seen.

A third possible basis for exclusion is that proxy access bylaws fall within the ordinary business operation exception.²⁰⁷ There has been little guidance on the excludability of proxy access proposals on this ground because they have been excluded instead on the ground to be discussed

202. *See id.* § 10.20.

203. *See supra* note 22.

204. Depending on particular circumstances, boards may try to exclude a proposal on bases other than the four mentioned in the text. If the language favoring the proposal contains attacks on the current board which can be painted as untrue, the board may argue that inclusion would violate federal securities law, in particular Rule 14a-9, which prohibits making false statements in a proxy solicitation. If previous proposals have been defeated by a large enough margin, the board may exclude a proposal under the prevention allowing exclusion of proposals that have been defeated by adequately large margins. If the proposal can be described as duplicating a board's own proposal, it may be excluded on that ground.

205. 17 C.F.R. § 14a-8(i)(1) (2008).

206. *Id.* § 14a-8(i)(2).

207. *Id.* § 141-8(i)(7).

next.²⁰⁸ In general, the SEC has held proxy access proposals that are aimed at corporate governance matters non-excludable on this ground.²⁰⁹ Proxy access would seem to fall squarely within that analysis, and hence should not be excluded on this basis.

The main obstacle to proxy access bylaws, until recently, was the exclusion of proposals that relate to an election.²¹⁰ There has been a lot of relevant action on this point in recent years. This recent action relates to an election exclusion that the SEC added to Rule 14a-8 in 1976.²¹¹ Early no-action letters interpreted the exclusion rather narrowly, forbidding exclusion of proposals that would regulate the election process.²¹² At some point in the eighties, the SEC staff began to allow exclusion of proposals regulating the election process if they were likely to lead to contested elections.²¹³ Under this interpretation, proxy access bylaws were excludable.

Shareholder activists became more and more interested in proxy access, and in 2003, the SEC floated a major change in its policy. Under the 2003 Proposal, corporations would have been required to follow a version of proxy access if one of two triggers were activated.²¹⁴ Once triggered, shareholders who collectively held at least five percent of the outstanding shares for at least two years could have nominated directors using the corporate proxy, but only for a minority of the open positions.²¹⁵ This Proposal received a huge number of comments,²¹⁶ but the SEC never acted on it.

Frustrated with the SEC, shareholders tried to get their way in court. In 2006, they succeeded with the Second Circuit. In *American Federation of State, County & Municipal Employees, Employees Pension Fund v. American International Group, Inc.*, the court held that the SEC's interpretation of its own rule was arbitrary.²¹⁷ In particular, the court objected to the agency's changed interpretation over the years with no

208. McDonnell, *Shareholder Bylaws*, *supra* note 5, at 259.

209. *Id.*

210. 17 C.F.R. § 240.14a-8(i)(8) (2011).

211. *Am. Fed'n of State, Cnty. & Mun. Emps., Emps. Pension Plan v. Am. Int'l Grp., Inc.*, 462 F.3d 121, 126–27 (2d Cir. 2006).

212. *Id.* at 128.

213. *Id.*

214. Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784, 60,786–805 (Oct. 14, 2003) (to be codified at 17 C.F.R. pts. 240, 249 & 274).

215. *Id.*

216. *See Comments on Proposed Rule: Security Holder Director Nominations*, SEC, <http://www.sec.gov/rules/proposed/s71903.shtml> (last modified July 9, 2009) [hereinafter *Comment Letters*].

217. *Am. Int'l Grp.*, 462 F.3d at 123.

reason given. The court read the exclusion more narrowly to only prohibit shareholders from using Rule 14a-8 itself as a direct basis for nominating directors through a Rule 14a-8 proposal.²¹⁸

This was a rather aggressive attack on the SEC's ability to interpret its own rule, and the SEC struck back. There was disagreement within the SEC as to how to respond. In 2007, the SEC set forth for comment two competing rule changes responding to the Second Circuit.²¹⁹ One of these amended Rule 14a-8 to reinstate the SEC's former interpretation allowing exclusion of proposals such as proxy access.²²⁰ The competing proposal would have allowed shareholders to propose proxy access bylaws under certain conditions, including a five percent share ownership requirement.²²¹ Ultimately, the SEC opted for the former approach, and again allowed boards to exclude proxy access proposals.²²²

B. *The SEC's Proposal—Default Rule*

However, that law has now changed. In June of 2009, the SEC floated a new proxy access proposal. This proposal had two main parts. The first provided a proxy access regime that applies to all companies governed by the SEC's proxy rules. The second main part allowed shareholders to modify that regime to provide more generous proxy access rules.²²³

The 2009 Proposal featured a new Rule 14a-11.²²⁴ This rule creates a proxy access regime. Shareholders who fulfill the requirements of that regime would be able to use the corporate proxy material to nominate directors. As proposed, leading features of that regime included the following:

- The nominating shareholders would collectively have to own more than a specified minimum percentage of the voting

218. *Id.* at 129–30.

219. Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56,161, Investment Company Act Release No. 27,914, 91 SEC Docket 575, 580–82 (July 27, 2007); Shareholder Proposals, Exchange Act Release No. 56,160, Investment Company Act Release No. 27,913, 72 Fed. Reg. 43,466, 43,469–80 (July 27, 2007) (to be codified at 17 C.F.R. pt. 240).

220. Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56,161, Investment Company Act Release No. 27,914, 91 SEC Docket 575, 580–82 (July 27, 2007).

221. Shareholder Proposals, Exchange Act Release No. 56,160, Investment Company Act Release No. 27,913, 72 Fed. Reg. at 43,469–80.

222. Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56,161, Investment Company Act Release No. 27,914, 91 SEC Docket at 580–82.

223. *See* 2009 Proposal, *supra* note 117, at 29,024.

224. *Id.* at 29,032, 29,082.

shares. The proposed minimum thresholds were one, three, or five percent, depending on the size of the corporation.²²⁵

- Shareholders would have had to hold those shares for at least one year.²²⁶
- The number of directors that can be nominated under this procedure is limited to no more than one nominee or twenty-five percent of the board, whichever is greater.²²⁷
- There is an elaborate procedure for resolving disputes over the application of the rules.²²⁸
- There are disclosure requirements for nominating shareholders and nominees.²²⁹

C. The SEC's Proposal—Altering Rule

The 2009 Proposal also proposed re-writing the “relates to an election” basis for exclusion. It significantly narrows this basis, allowing for exclusion only if a proposal:

- “Would disqualify a nominee who is standing for election;”²³⁰
- “Would remove a director from office before his or her term expired;”²³¹
- “Questions the competence, business judgment, or character of one or more nominees or directors;”²³²
- “Nominates a specific individual for election to the board of directors, other than pursuant to Rule 14a-11, an applicable state law provision, or a company’s governing documents;”²³³
or
- “Otherwise could affect the outcome of the upcoming election of directors.”²³⁴

225. *Id.* at 29,035, 29,083 (to be codified at 17 C.F.R. 240.14a-11(b)(1)).

226. *Id.* at 29,037, 29,083 (to be codified at 17 C.F.R. 240.14a-11(b)(2)).

227. *Id.* at 29,043, 29,084 (to be codified at 17 C.F.R. 240.14a-11(d)).

228. *Id.* at 29,075–76, 29,084 (to be codified at 17 C.F.R. 240.14a-11(f)).

229. *Id.* at 29,074–76, 29,085 (to be codified at 17 C.F.R. 240.14a-18).

230. *Id.* at 29,082 (to be codified at 17 C.F.R. 240.14a-8(i)(8)(i)).

231. *Id.* (to be codified at 17 C.F.R. 240.14a-8(i)(8)(ii)).

232. *Id.* (to be codified at 17 C.F.R. 240.14a-8(i)(8)(iii)).

233. *Id.* (to be codified at 17 C.F.R. 240.14a-8(i)(8)(iv)).

234. *Id.* (to be codified at 17 C.F.R. 240.14a-8(i)(8)(v)).

That final language is ominously open-ended and could potentially be used to block proxy access bylaws. However, the Proposing Release makes clear that a much narrower interpretation is intended, covering only proposals “that are comparable to the four specified categories and would undermine the purpose of the exclusion.”²³⁵

This amendment to Rule 14a-8 would allow shareholder bylaw proposals that provide for proxy access on more generous grounds than the proposed Rule 14a-11. But these bylaws would restrict proxy access to narrower terms than the proposed Rule 14a-11.²³⁶

D. *The SEC Proposal—Reaction*

Thus, this proposal changed both the default rule and the altering rule for proxy access. The prior default rule was no proxy access.²³⁷ The new default rule would be proxy access for shareholders who met the ownership and other restrictions of proposed Rule 14a-11.²³⁸ The prior altering rule was that boards could provide for proxy access, and that shareholders (at least in Delaware, and probably other states as well) could provide for proxy access in a bylaw, but they had to cover the high costs of a proxy solicitation if they want to enact such a bylaw.²³⁹ The new altering rule would lower the costs to shareholders for enacting proxy access bylaws with more generous access than proposed Rule 14a-11, but would completely block boards or shareholders from setting proxy access rules that are more restrictive than 14a-11.²⁴⁰

The SEC received a large number of comments on this proposal. The comments were relatively predictable. Corporate managers and the law firms that represent them are not happy.²⁴¹ They would prefer no change to the status quo, and to the extent that some change does happen, they would prefer two alternatives.²⁴² The better (from their point of view) of these alternatives would be to amend Rule 14a-8 as suggested but leave out the

235. *Id.* at 29,058.

236. *Id.*

237. Except for North Dakota corporations. N.D. CENT. CODE ANN. § 10-35-08 (West, Westlaw through 2009 Regular Session) (granting right to proxy access to shareholders holding over five percent of outstanding shares).

238. 2009 Proposal, *supra* note 117, at 29,082–85.

239. See discussion *supra* Part IV.C–D.

240. 2009 Proposal, *supra* note 117, at 29,024, 29,031.

241. See, e.g., Letter from Sullivan & Cromwell et al., to SEC 1–7 (Aug. 17, 2009), available at <http://www.nylj.com/nylawyer/adgifs/decisions/081909letter.pdf>.

242. Letter from Cravath, Swaine & Moore LLP et al., to SEC 14 (Aug. 17, 2009), available at <http://www.nylj.com/nylawyer/adgifs/decisions/081909letter.pdf>.

new Rule 14a-11. Under this alternative, the default rule would remain no proxy access for nominations, but shareholders could use Rule 14a-8 to propose bylaws that allow for proxy access. The other alternative that manager-friendly groups suggested was to follow the SEC's proposal, but allow shareholder bylaws that alter the new Rule 14a-11 in any direction, including bylaws that restrict access more than Rule 14a-11.²⁴³

Shareholders and groups that represent them were mostly favorable to the SEC's proposal.²⁴⁴ Law professors who commented on the proposed rules mostly favored the proposal as well.²⁴⁵ A major exception is Joseph Grundfest, who argued that the proposal is "arbitrary and capricious" and should be struck down by courts if enacted.²⁴⁶ His core argument is that the central rationale for proxy access is that shareholders should be trusted to nominate and choose directors, and yet the proposal does not trust shareholders to enact proxy access rules that are stricter than those of Rule 14a-11.²⁴⁷ Grundfest argues that the SEC gives no reason for trusting shareholders on the former point given that it does not trust them on the latter point.

Part of the reason for the SEC's delay of a little over a year in enacting its proposal was some doubt as to whether it had the statutory authority to do so. That changed in the summer of 2010 with the enactment of financial regulation reform. A section of the Dodd-Frank Act explicitly gave the SEC

243. *Id.* at 1.

244. *See, e.g.*, Letter from Kenneth Colombo, Fund Coordinator, Sheet Metal Workers Nat'l Pension Fund to SEC 1 (Aug. 17, 2009), *available at* <http://www.sec.gov/comments/s7-10-09/s71009-283.pdf>; Letter from Warren L. Mart, Gen. Sec'y and Treasurer, Int'l Ass'n. of Machinists, to SEC 1 (Aug. 17, 2009), *available at* <http://www.sec.gov/comments/s7-10-09/s71009-319.pdf>; Letter from the Bd. of Dirs. of Shareowner Educ. Network, to SEC 3 (Aug. 17, 2009) (on file with the SEC), *available at* <http://www.sec.gov/comments/s7-10-09/s71009-496.pdf>.

245. *See* Letter from Lucian Bebchuk on Behalf of a Bi-Partisan Group of 80 Professors, to SEC 1 (Aug. 17, 2009), *available at* <http://www.sec.gov/comments/s7-10-09/s71009-282.pdf>.

246. *See* Letter from Joseph Grundfest, Co-Director, Professor of Law and Bus., Stanford Law Sch., to SEC 1 (July 24, 2009), *available at* <http://www.sec.gov/comments/s7-10-09/s71009-64.pdf>. The Business Roundtable has used this argument in the case which has caused the SEC to stay the new rules. *See* Order Granting Stay, Securities Act Release No. 9,149, Exchange Act Release No. 63,031, Investment Company Act Release No. 29,456, 2010 SEC LEXIS 3275 *passim* (Oct. 4, 2010). For an argument that the new law is not arbitrary and capricious, *see generally* Reed T. Schuster, *Rule 14a-11 and the Administrative Procedure Act: It's Better to Have Had and Waived, Than Never to Have Had at All*, 95 MINN. L. REV. 1034 (2011).

247. Letter from Joseph Grundfest, Co-Director, Professor of Law and Bus., Stanford Law Sch., to SEC 4 (January 18, 2010), *available at* <http://www.sec.gov/comments/s7-10-09/s71009-599.pdf>.

authority to enact rules regulating proxy access.²⁴⁸ Very soon afterward, the SEC enacted its new rules.

E. *The SEC's New Rules*

The SEC's final rules were close to the proposed rules, but there were some significant changes to the default rule under Rule 14a-11. The main changes were as follows:

- The proposing shareholder group must own three percent of the outstanding shares, a level that applies for all corporations rather than the sliding one/three/five percent scale of the proposal.²⁴⁹
- The shareholders must have held shares at or above the three percent level for at least three years, rather than the one year holding period of the proposal.²⁵⁰
- Should two or more groups make nominations for the same election, the group with the most shares wins out, rather than the first to file as in the proposal.²⁵¹

The altering rule in the final rule was as proposed. That is, Rule 14a-8 was amended as described above.²⁵² Shareholders can now make bylaw proposals that make proxy access available on more generous terms than Rule 14a-11. However, they cannot make proxy access available on more stingy terms. The SEC has stayed its new rule pending judicial resolution of a case brought by the Business Roundtable.²⁵³

In sum, the SEC's actions in this area recently, like those of Delaware, are broadly typical of what we should expect from that relationship. In devising a new default rule for proxy access, the SEC stepped in to correct the overly pro-manager bias we sometimes see in Delaware. But the SEC has gone too far and enacted an overly rigid rule. The SEC is prone to lose sight of the advantages of experimentation and variation that decisionmakers in Delaware are so well aware of.

248. Dodd-Frank Act, Pub. L. No. 111-203 § 971, 124 Stat. 1376 (2010).

249. 17 C.F.R. § 240.14a-11(b)(1) (2011).

250. Shareholder Nominations, 75 Fed. Reg. 56,782, 56,782 (Sept. 16, 2010) (to be codified at 17 C.F.R. § 240.14a-11(b)(1)).

251. *Id.* at 56,786 (to be codified at 17 C.F.R. § 240.14a-11(e)).

252. Shareholder Proposals, 75 Fed. Reg. 56,782, 56,782-86 (Sept. 16, 2010) (amending 17 C.F.R. § 240.14a-8); Adopting Release, *supra* note 15, at 56,668.

253. *See* Order Granting Stay, Securities Act Release No. 9,149, Exchange Act Release No. 63,031, Investment Company Act Release No. 29,456, 2010 SEC LEXIS 3275 *passim* (Oct. 4, 2010).

VI. THE OPTIMAL RULES

How do these state and federal developments fare when considered in light of the policy considerations discussed in Part III? Let us consider first the optimal default rule, then the optimal altering rule, and finally the optimal mix of federal and state rulemaking in this area.

A. *Optimal Default Rule*

It is increasingly hard to defend no proxy access as a default rule. The leading approach to setting default rules is to determine the majoritarian rule, which is the rule that shareholders in a majority of corporations would set if they could costlessly consider and bargain over the rule in question.²⁵⁴ Of course, determining what the majoritarian rule is for a disputed topic is not so easy.

No proxy access, of course, has been the dominant practice for the history of American corporations. This historical dominance gives it some claim to being the majoritarian default—if it were a blatantly bad rule, then presumably more corporations would have opted out. However, the altering rule that has been in place reduces the weight of that argument. The no-proxy-access default rule favors the board, and the altering rule makes it quite hard for shareholders to opt out of that rule without board approval. If this pro-board rule were truly awful, then the gains from altering it would have induced some boards to offer a different rule. But given the private gains directors and officers get from this pro-board rule it seems likely that companies will not opt out of it as long as it is only moderately bad.²⁵⁵

Today there is clearly a strong interest in proxy access. Many institutional investors would like to see it.²⁵⁶ As argued in Part III, shareholder election of boards is a universal feature of American corporations, and one that the principle of accountability clearly justifies. Delaware case law also stresses the importance of the shareholder franchise as legitimating the power vested in boards.²⁵⁷ And yet, shareholder elections in American public corporations are mostly a sham because of board control over the nominating procedures and the high costs of proxy solicitations.²⁵⁸ To this must be added the effective antitakeover defenses now in place at most American corporations, which rule out the one situation in which

254. See Ayres & Gertner, *supra* note 9, at 93.

255. Bebchuk & Hamdani, *supra* note 93, at 492; see also *supra* text accompanying note 93.

256. See, e.g., *Comment Letters*, *supra* note 216.

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

258. See Bebchuk, *supra* note 22, at 688–94.

shareholder elections can play a real role.²⁵⁹ In light of all this, it is hard to believe that no proxy access is what shareholders in a majority of public corporations would choose if they could act costlessly.²⁶⁰

We considered in Part III whether systematic shareholder mistakes or the bias of shareholder activists may support a no-proxy-access default rule. To succeed, these arguments must establish not only that most shareholders are ill-informed on most topics or that shareholder activists may have interests that differ from those of other shareholders. The arguments must further show that a majority of shareholders will typically, or at least too often, be unaware of their own limitations and those of shareholder activists. But why should that be? Throughout history, shareholders have typically deferred to boards because they knew well that directors were better informed than they. Why should that not still be the case, except in circumstances where there is pretty strong evidence of a board that is either incompetent or not pursuing shareholders interests?

There are other ways to think about setting default rules besides the majoritarian approach. Penalty default rules may be unattractive to one party in order to induce that party to share private information by acting to change the default.²⁶¹ In the context of public corporations, officers and directors are the party most likely to have private information. Thus, setting a default rule against their interests seems suggested by this approach. No proxy access is certainly not such a default.

A related approach to setting default rules for corporate law has been suggested by Bebchuk and Hamdani. They suggest setting pro-shareholder defaults because boards can act more easily to change default rules than can shareholders.²⁶² Thus, if the pro-shareholder default rule is optimal, it will stay in place, while if a more pro-manager rule would be better, it will be easy to opt in to the better rule. In contrast, if the default rule is pro-manager but the better rule is pro-shareholder, many corporations might not opt in to the better rule. Once again, this approach does not favor the no-proxy-access default rule.²⁶³

Perhaps the best defense of the no-proxy-access default rule is that it is simplest. Once one decides to set a rule favoring some degree of proxy access, there are lots of choices to make as to who will get access. These

259. See Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 890 (2002).

260. Bebchuk & Hirst, *supra* note 75.

261. Ayres & Gertner, *supra* note 9, at 97.

262. Bebchuk & Hamdani, *supra* note 93, at 491–92; see also Bebchuk & Hirst, *supra* note 75.

263. See Bebchuk & Hirst, *supra* note 75, at 333–50 (Bebchuk and Hirst argue this at length for proxy access).

choices get complex and rather arbitrary. It may be best to stand back, set a simple no access default rule, and then let shareholders step in, opt out, and design the details of an access system themselves.²⁶⁴

Perhaps, but I tend to think not. After all, we generally do not want shareholders designing detailed policies. A leading defense of corporate law as setting optimal defaults is that it makes such detailed choices in plausible ways, avoiding the necessity for individual companies to reinvent the wheel each time.²⁶⁵ A no-access rule is easy to write; if the default rule allows for proxy access, it is very easy to write down a rule that provides for access instead of a rule for no access.

In contrast, a proxy access regime involves setting rules along a number of different dimensions, as one can see from the outline above of Rule 14a-11.²⁶⁶ What threshold level of shares should nominating shareholders be required to own? How long should they be required to have owned them? How many directors should they be able to nominate? What should they be required to disclose? And so on. These rules will be lengthy. Indeed, as Bebchuk and Hirst point out, a shareholder proposal which tried to set out such rules from scratch would be much longer than the allowed limit under Rule 14a-8.²⁶⁷ We avoid transaction costs by not requiring each corporation that wants to allow for proxy access to write these rules from scratch. Where a corporation wants to allow for some proxy access, but is not satisfied with the exact rules of a default proxy access regime, it can write a short opt-out provision that simply addresses the dimensions on which it chooses to vary from the default (e.g., a threshold shareholding level of five percent rather than three percent).

But how do we decide which of the many possible default settings for the various relevant dimensions are best? Grundfest argues that the SEC should conduct a random survey of shareholder preferences before finalizing its rule if it chooses (against his wishes) a proxy access default rule.²⁶⁸ It is not a bad idea. But after all, agencies make educated guesses about the best way to set debatable rules all the time without conducting such surveys. The SEC surely received plenty of input on its proposal. Most importantly, the opt-out mechanism, if modified as I suggest, would give the SEC a good way to calibrate its rule over time. If it finds that

264. This is basically Grundfest's argument for an opt-in regime with no proxy access as the default. See Grundfest, *supra* note 86, at 385–87, 392–93.

265. EASTERBROOK & FISCHER, *supra* note 16, at 34–35.

266. See *supra* notes 223–36 and accompanying text.

267. Bebchuk & Hirst, *supra* note 75, at 341. One could of course increase the 500-word limit. However, that seems unattractive if one is concerned about the transaction costs already associated with shareholder proposals.

268. Grundfest, *supra* note 86, at 385.

shareholders in a large fraction of corporations are opting out of the Rule 14a-11 default in a particular way, the agency can modify the rule accordingly.

So the simplicity argument for a no-proxy-access default rule is not persuasive, and most of the other arguments above for how to set default rules argue against the no-proxy-access default rule. The default rule, therefore, should set out a regime that allows relatively generous proxy access.²⁶⁹

B. *Optimal Altering Rule*

As for the optimal altering rule, the argument for giving shareholders significant authority to alter the default rules for proxy access is quite strong. Shareholder election of directors is a core legitimate and legitimating shareholder power. This is an area where directors are tempted to set sub-optimal rules that entrench themselves. It is not an area where shareholders would be exercising power over complex questions of operational decisions that are beyond their judgment. Accountability within principle/agent rules thus strongly favors giving the shareholders the ability to opt out of the prevailing default rule. Flexibility and freedom of contract also support a strong shareholder role in the altering rule because boards will not be likely to act to change a default rule that favors them even if the change would be efficient.

The SEC's new rules have an asymmetric altering rule: they allow shareholders to opt for more generous proxy access than the default rule, but not more stingy access. Does this make sense? The proposal is clearly correct in prohibiting boards from opting out of the Rule, without shareholder approval, in a more stingy direction—given the self-interest of boards that justifies the proxy access default in the first place. Such a board opt-out procedure would be blatantly self-defeating. Other safeguards on a shareholder opt-out also make sense.²⁷⁰

But why not let shareholders opt out in any way they choose? Professor Grundfest has put the point rather too strongly, but his basic thrust is on target.²⁷¹ If we trust shareholders to nominate directors, why not also trust

269. Relatively generous because it is easier for boards to move to a less generous alternative than for shareholder activists to move to a more generous alternative. *See* Bebchuk & Hirst, *supra* note 75, at 338–39.

270. *Id.* at 356–58 (outlining important safeguards).

271. Grundfest is wrong, though, as to what the default rule should be. He argues for a no-access default rather than the 14a-11 default. Grundfest, *supra* note 86, at 362. He says the SEC's proposal assumes without evidence that a majority of shareholders prefer the 14a-11

them to choose different rules than the SEC has chosen? The SEC's one-way ratchet seems to protect shareholders against themselves, but is that really necessary? Why? Perhaps the principle of accountability suggests the one-way ratchet as a way to avoid board manipulation of a more flexible rule. But, there are clear benefits to allowing opting out in any direction. Although proposed Rule 14a-11 makes what I find to be quite reasonable guesses as to the balance between allowing shareholders access and not making access so easy as to encourage nuisance actions, it is possible it has not gotten the balance right, either in general or for some corporations. A more flexible altering rule allows for more experimentation and tailoring, and also gives more authority to shareholders. If the SEC's default rule does have serious problems, we should be able to observe and correct them as shareholders in many corporations opt out of the objectionable elements. Absent some strong argument,²⁷² it is very hard to see why we should limit shareholder authority to set whatever proxy access rules a majority of them choose.

The SEC's response to its critics on this point is that proxy access is a right for each individual shareholder. We are not generally in the habit of allowing a majority of shareholders to waive rights guaranteed under the securities law for all shareholders, and we should not do so with this right either.²⁷³ But if this is such a hallowed individual right, why has the SEC limited it in effect to such a small group of shareholders with the three percent/three year requirements, which very few will be able to meet, even acting in groups? The defense for those restrictions is they balance the gains from allowing shareholders to participate in voting with the possible costs and disruptions that proxy access may cause.²⁷⁴ But that sort of balancing is not how we treat rights, it is how we make hard judgment calls in crafting proper corporate governance regimes. I think the SEC has made plausible judgment calls in crafting Rule 14a-11. However, it and I may be wrong,

rules to no access. *Id.* at 367, 385. However, Grundfest himself makes the opposite assumption, and initially presented no evidence for it. *See id.* at 365. Grundfest now points to some empirical evidence that share prices have reacted negatively to the SEC's proposal. Joseph A. Grundfest, *Measurement Issues in the Proxy Access Debate 2-3* (Rock Ctr. for Corp. Governance, Working Paper No. 71, Stanford Univ. Law Sch. Law & Econ. Olin, Working Paper No. 392, 2010), available at <http://www.ssrn.com/abstract=1538630>. Such evidence, though, is quite sensitive as to how to choose dates for the event study, and what else was happening on those dates. Moreover, even if the studies do persuasively suggest the market has reacted negatively to the SEC's proposal, that could be due to concerns over its overly-rigid altering rule rather than its default rule.

272. Bebchuk and Hirst take a stab at such arguments, but do not convince themselves. Bebchuk & Hirst, *supra* note 75, at 351-53.

273. Adopting Release, *supra* note 15, at 56,673.

274. *Id.* at 56,690.

either in general or for some specific companies. The shareholders should be allowed to make differing judgment for themselves.

Thus, to some extent our two core principles of accountability and freedom of contract are at odds on the issue of whether shareholders should be allowed to opt for more restrictive proxy access than allowed by the default Rule 14a-11. Accountability gives some justification for the SEC's approach. However, it is a weak justification that appears to be protecting shareholders against themselves in a way that is in serious tension with expanded shareholder power. Freedom of contract, by contrast, strongly favors allowing shareholders to opt out in any direction they choose.

So, the optimal default rule would provide for relatively generous proxy access, and the optimal altering rule would allow shareholders to opt out of the default rule in any direction they choose.

C. *Federalism*

How do the developments in Delaware and the SEC's new rules match up against these optimal rules?

Delaware now looks pretty good, but far from perfect. The straying from perfection may well represent the modest managerialist tilt of Delaware law. But the fact that Delaware has not strayed too far in a managerialist direction probably reflects both the role that shareholders and markets play in creating incentives for Delaware lawmakers and also the restraining influence due to the threat of federal preemption.²⁷⁵

The default rule in Delaware remains no proxy access. This is in part a result of the fact that proxy regulation has for decades now been largely a matter of federal regulation. Delaware law has thus been able to afford to be under-developed in this area. Nonetheless it is possible for states to set explicit rules for proxy access—one state, North Dakota, has done so.²⁷⁶ Delaware could and should follow suit.

Although Delaware's default rule is faulty, its altering rule is better. Delaware gave shareholders more power to opt out in *CA, Inc.* and the new section 112.²⁷⁷ Even though the default rule may not be great, at least shareholders now have the power to design their own systems of proxy access without requiring board approval.

Three features, though, limit the effectiveness of this altering rule at present. First, the probable need to include a fiduciary duty out provision in

275. See *supra* notes 121–23 and accompanying text.

276. See *supra* note 132 and accompanying text.

277. See *supra* Part IV.

proxy access bylaws is at least a nuisance. One hopes that other states will not follow this silly development in Delaware. Second, the possibility that boards may be able to amend or repeal shareholders proxy access bylaws is at least annoying, and may work out to be worse than annoying in practice, although one hopes not. Luckily boards cannot do this in many other states, including those that follow the Model Business Corporation Act.

The third feature limiting the effectiveness of the current altering rule comes through the practical difficulty of shareholder action to enact bylaw amendments. Conceivably, state law could act to help overcome this collective action problem. However, federal securities law helped place obstacles to shareholder action through voting in the first place.²⁷⁸ Moreover, Rule 14a-8 has now been entrenched for decades as the main tool for overcoming this kind of collective action problem. Thus, it makes sense to look to federal securities law for handling this problem, and Rule 14a-8 is the traditional way to encourage shareholder collective action. It therefore made a great deal of sense to change the old interpretation of Rule 14a-8. This is what blocked shareholders from effectively using their bylaw power under state law to set their own proxy access rules.

Additionally, the new SEC rules go beyond this change in the altering rule to also change the default rule. They also harden the altering rule by not allowing shareholders to opt out of the proposed new default in a way that restricts access. Are the new rules justified in these elements?

In setting a new default rule, the SEC indeed is justified. We have seen above that there are many arguments against, and few arguments for, the no-access default rule that prevails in almost every state. A new default rule that allows for some proxy access is clearly justified. One might prefer to see the states setting up proxy access default regimes. One can imagine states setting up a variety of access regimes. As long as Delaware's rule was not too limited, we could well stand to learn a lot from experimentation at the state level. However, states (aside from North Dakota) are not doing this. This seems to be an instance of the overly managerialist tilt of state corporate law. When that tilt manifests itself, it is time for the federal government to step in and set the balance right.²⁷⁹ That time has come with proxy access.

This conclusion is strengthened by the fact that for decades we have looked mostly to federal rather than state law in setting the rules for proxy solicitations, and that the federal proxy rules themselves helped to create the high costs of independent solicitation which make Rule 14a-8 a necessity in

278. Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 822-24 (1992).

279. See *supra* notes 121-23 and accompanying text.

the first place.²⁸⁰ Given state recalcitrance and traditional federal involvement in this area, it is appropriate for the SEC to set a better default rule where all but one state has failed to act. Thus, those managers, corporate lawyers, and others who call for only a revision to Rule 14a-8 without the new Rule 14a-11 are wrong.²⁸¹

As we have seen above, the optimal altering rule would allow shareholders to opt out in any direction, unlike the asymmetric altering rule of the SEC's rules. Also, a balanced approach to federalism suggests that the SEC should be wary of encroaching too far on the ability of states and corporations to experiment with different rules. It is probably right for the SEC to step in and set a new default here, but the altering rule should soften that move by allowing flexibility where shareholders so choose.

Thus, the SEC in many ways has improved matters with the new default rule, Rule 14a-11. It was also a good idea to limit the old relates to an election exclusion. However, the SEC should allow shareholders (not boards) to opt out of Rule 14a-11 in any direction they choose (though, of course, boards should be allowed to opt out in a direction that is more generous to shareholders than Rule 14a-11).

D. Summary

We can summarize the alternatives as follows. One can envision the core possible rules on the following grid, reflecting choices both as to default rules and altering rules. The default rule may be set in a way that allows for no proxy access or some degree of access. The altering rule can be set in a way that makes it hard for shareholders to alter the default rule or easy to alter the default rule.

280. See Black, *supra* note 278, at 824.

281. That is not to say that I agree with all details of new Rule 14a-11 as a default rule. The appropriate ownership threshold is debatable, though it strikes me as a quite reasonable guess. Having a holding period for nominating shareholders to avoid short-termism makes sense, but three years may be too long. More importantly, I am not at all convinced that shareholders should be limited in the number of nominees they can include, as Rule 14a-11 does. For empirical evidence that this limitation will help make proxy access little used, see generally Marcel Kahan & Edward B. Rock, *The Insignificance of Proxy Access* (N.Y. Univ. Law & Econ., Working Paper No. 10-51, 2010), available at <http://www.ssrn.com/abstract=1695682>.

		Altering Rule	
		Hard to alter	Easy to alter
Default Rule	No access	Old status quo	New Rule 14a-8 but not Rule 14a-11
	Access	SEC rules with respect to access rules less generous than Rule 14a-11	SEC rules with respect to rules more generous than Rule 14a-11 My suggestion with respect to moves in any direction from Rule 14a-11

The old status quo is in the upper left box, with a default rule of no access and an altering rule that made opting out of that default rule hard given the old interpretation of Rule 14a-8 (although the altering rule would have made the default even harder to change had Delaware interpreted its law to not allow shareholders to enact proxy access bylaws). In the box to the right of this is the suggestion of many opponents of the SEC's proposal that the SEC drop Rule 14a-11, but retain the revision of Rule 14a-8. The default rule would then be no access, but it would become much easier for shareholders to alter that rule. The SEC's new rules are somewhat ambiguously situated within these alternatives. The SEC's rules change the default rule to support proxy access, and hence they fit in the bottom row. They fit within the bottom left box with respect to access rules that are less generous than Rule 14a-11: for those rules, it is extremely hard (harder than before the new rules) to opt out of the default rule. The SEC's rules fit within the bottom right box with respect to access rules that are more generous than Rule 14a-11: for those rules, shareholders can more easily than before opt out of the default rule. My own suggestion is that we should move entirely within that bottom right box: use Rule 14a-11, or something close to it, as the default rule, but make it easy for shareholders to opt out of that rule in any direction they choose.

The similarity of many of the arguments surrounding shareholder power and board accountability as applied to both the default rule and the altering rule suggests a strong pull of attraction to the positions along the upper left-lower right diagonal. The upper left box represents a judgment that more shareholder power is unattractive in both the default rule and the altering rule. The lower right box represents a judgment that more shareholder power is attractive in both rules. Are either of the off-diagonal positions

defensible? Above we suggested arguments that may support them,²⁸² but they are a bit of a stretch. Grundfest makes a strong case for the inconsistency of the lower left position in the SEC's new rules, but fails to note the problems with his own position in the upper right box.²⁸³ If he believes shareholders can make sensible decisions in voting on proxy access bylaw proposals, why does he not believe they can make sensible decisions in choosing among competing board candidates? Perhaps one can mount a good argument distinguishing the ability of shareholders to make these two kinds of decisions. I am unaware of anyone having done so to date.

E. What Next? Possible Board Responses

Over the next few years we may start to see shareholders use the Rule 14a-11 process to nominate directors and/or see bylaw proposals put in place more generous processes. Given the rather high hurdle of the three percent / three year eligibility rules, I would not expect to see many shareholder nominations, but presumably there will be some. That is not the end of the story, though. Many boards will be unhappy with this incursion on their power, and will look for ways to prevent shareholder nominations or blunt their impact.

J.W. Verret has suggested a number of ingenious strategies boards might use. These include charter amendments preventing public and union pension funds from voting, golden or tin parachutes triggered by election contests, dividends contingent upon no shareholder-nominated directors, share issuances to reduce voting levels, director resignation policies, withholding indemnification or insurance from shareholder directors, buying out the shares of nominating groups, director qualification bylaws, election expense bonds, and poison pills with low thresholds triggered by shareholder communications in advance of proxy contests.²⁸⁴ If Verret is right, we may see an explosion of litigation concerning the validity of these defenses similar to the hostile takeover litigation of the eighties and nineties.

But I offer several cautions concerning Verret's practical and legal analysis. On the practical side, we may not see a rapid proliferation of the defenses he suggests, for at least two reasons. First, as just mentioned, the Rule 14a-11 requirements are strenuous enough that few shareholders may

282. See *supra* note 118 and accompanying text.

283. See *supra* note 271.

284. J.W. Verret, *Defending Against Shareholder Proxy Access: Delaware's Future Reviewing Company Defenses in the Era of Dodd-Frank*, 36 IOWA J. CORP. L. 391, 393-95 (2011).

be able to meet them, so boards may feel little actual threat. Second, even if boards do feel threatened, they may not be wise to use the defenses Verret suggests, at least not the more extreme ones. Many of them strike me as serious slaps in the face of shareholders, and attacking your shareholders is not generally the best of ideas. Among other things, shareholders may fight back. For some of Verret's proposals, one can readily imagine shareholders countering with bylaws of their own—e.g., a bylaw requiring that no director be indemnified or insured at a higher level than any other level. Or, shareholders angered by one of Verret's suggestions could enact a proxy access bylaw with more generous terms than Rule 14a-11, in particular, bylaws which allow shareholders to nominate a majority of board positions, and then proceed to use that to take control of the board and eliminate whatever defense the board had put in place.

On the legal side, as Verret recognizes, much will depend upon whether and how the Delaware courts use the *Blasius* standard to review such defenses. Verret suggests that the courts may not believe *Blasius* applies to the exercise of a federal nomination right, as opposed to a right given by state law or by the corporate charter or bylaw.²⁸⁵ I do not think the courts should follow Verret on this point. Although the mandatory nature of Rule 14a-11 is indeed objectionable, nonetheless the rule does work to make the shareholder franchise more real. The Delaware Supreme Court recognized in *CA, Inc.* that the right to vote without a right to affordably affect who is on the ballot is a limited right indeed, and attempts to strengthen that right are well within the protected sphere of *Blasius*.²⁸⁶ Moreover, if the courts did follow Verret in distinguishing the federal nomination right as not deserving *Blasius* protection, it would create an incentive that boards might not appreciate. Shareholders would then have stronger reason to enact their own bylaw giving more generous access than Rule 14a-11, since a nomination process under such a bylaw would clearly be subject to *Blasius* protection.

On the other hand, I do agree with Verret that it makes some sense to soften the *Blasius* standard, so that when *Blasius* is invoked as applying to the facts of a case it is not in effect dispositive as deciding the case for shareholders. With such a tough standard, courts will be hesitant to invoke it. A standard that goes further in balancing the board's interest will be a standard that courts are more willing to use. But courts should not dilute *Blasius* all the way down to the weak *Unocal* standard, the analog for takeover defenses. As Bebchuk points out, the court in *Unocal* defended its

285. *Id.*

286. *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 237 (Del. 2008).

weak standard there in part with the argument that if shareholders are unhappy with a takeover defense, they can replace the board.²⁸⁷ Making it easy for boards to block shareholders from replacing them would make a travesty of the accountability mechanisms supposedly embedded within corporate law.

VII. CONCLUSION

Shareholder activism and demand for proxy access to nominate board candidates have increased dramatically over the past decade. In response, Delaware's law has moved somewhat closer to an optimal rule for shareholder proxy access as *CA, Inc.* and the new section 112 have made it clear that shareholders may amend the bylaws to allow for proxy access. Delaware has not yet made it to the optimal rule, though. The annoying fiduciary duty out requirement and the possibility of board counter-amendments reduce somewhat the effectiveness of the bylaw power. More importantly, the default rule remains no proxy access. Delaware's movement, and its relation to the optimal rule, are entirely in keeping with its general pattern. It shows flexibility and a willingness to adapt to changing circumstances in a move towards the optimum. That is particularly so in the face of threatened federal intervention. However, it remains short of the optimum, in a direction that favors the interests of managers over shareholders.²⁸⁸

Where Delaware's managerialism keeps it far enough away from the optimum, federal intervention in corporate governance rules becomes attractive. That is particularly so where as here federal rules burdening shareholder participation in the proxy process have been a good part of the problem.²⁸⁹ But that federal intervention should be as modest as possible and reserve as much space for state and individual company variation as possible.

The circumstances of corporate governance failures and financial crisis do indeed seem to have pushed the SEC closer to an optimal response. The new proxy access rules get us closer. They set a quite plausible default rule and improve upon the old altering rule in one direction by facilitating shareholder bylaw proposals that would allow more generous access than the default rule under Rule 14a-11. Had the SEC responded to strong pressure against its proposal by retaining Rule 14a-11 and the revisions to

287. Bebchuk, *supra* note 22, at 680.

288. *Supra* notes 68–70 and accompanying text.

289. Black, *supra* note 278, at 822–24.

Rule 14a-8, but allowing shareholder bylaws to opt out of the Rule 14a-11 default in any direction, we would have actually reached what I take to be the optimal set of rules in this area.

Alas, the SEC did not back down, and hence we have not yet reached the optimal set of rules. But one can hope that if in the future the SEC backs down in the face of a backlash, it will do so only by allowing shareholders to opt out in any direction they choose. If that happens, we will have reached a fully optimal set of default and altering rules for shareholder proxy access.
