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Article

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INTRODUCTION

In the past several decades, the corporate governance[1] landscape has changed dramatically and positively. In the 1960s, widely-dispersed individuals, with few resources and little incentive to monitor corporate management, still owned 80% of all corporate stock.[2] Since that time, institutional investors' share ownership has increased exponentially. Institutional ownership of publicly-traded corporations increased from 6.1% in 1950 to 70% in 2016.[3] This concentration of ownership brought with it the opportunity for shareholders to have a stronger voice both in corporate governance and on important social issues in our society.

Recently, shareholders have found new ways to directly impact the governance regime and the board of directors. These

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1. As used here, corporate governance is the system and process by which power and decision-making is allocated among the corporation's shareholders and other stakeholders, primarily the board of directors and corporate management, but also including creditors, customers, suppliers, government, and society as a whole. It consists of the laws, rules, practices, and processes by which a company is directed and controlled.

2. Andrew E. Nagel et al., *The Williams Act: A Truly "Modern" Assessment,* HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 22, 2011), https://corpgov.law.harvard.edu/wp-content/uploads/2011/10/The-Williams-Act-A-Truly-Modern-Assessment.pdf.

3. Paula Loop, Catherine Bromilow & Leah Malone, *The Changing Face of Shareholder Activism,* HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG., (Feb. 1 2018) https://corpgov.law.harvard.edu/2018/02/01/the-changing-face-of-shareholder-activism/#more-104497.

new means derive from various sources, including a more favorable regulatory environment and the influence of proxy advisory firms. The results have been amazing, including majority votes for director elections, declassification of corporate boards, shareholder approval of executive pay, and proxy access for shareholder nominees for board seats. Shareholder proposals on a multitude of social issues, from environmental concerns, such as climate change and sustainability, to board diversity and gender pay gap issues, have been vetted with some success. This movement and increased role for shareholders suggests that something approaching shareholder democracy[4] might actually be possible. Moreover, it shows that shareholder democracy is part of the broader democratic movement in our society.

Unfortunately, the latest development in shareholder activity has gone counter to this trend. As happens in the political sphere, where power exists, preference is sought. The result in the corporate sphere is the rise of special interest corporate governance. Activist investors are increasingly working outside the main governance mechanisms to advance private agendas.[5] They acquire an ownership stake in the company that is too small to command any change in the target company but then advocate for that change nevertheless. Among such advocacy tactics are threats to unseat the board, get rid of current management, or seek a sale or breakup of the target company.[6] These activists threaten to take these demands directly to the other shareholders and to have these results occur through a proxy fight at the upcoming annual meeting of the company. The only alternative the activist offers to this, potentially very public, corporate war is that the target company's board agree to special concessions and benefits for the activist alone.

Corporate boards may be intimidated by these tactics. The result is often that the target company board accedes, with the activist and the board cutting a private deal, whether termed a

4. Shareholder democracy refers to the ability of shareholders to dictate or influence the policy, governance, functions, and decisions of the corporation, either directly or through the board of directors and management, as a result of shareholders' ownership rights.

5. Martin Lipton, *Dealing with Activist Hedge Funds and Other Activist Investors,* HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 26, 2017), https://corpgov.law.harvard.edu/2017/01/26/dealing-with-activist-hedge-funds-and-other-activist-investors ("There are more than 100 hedge funds currently engaged in frequent activism and over 300 others that have launched activism campaigns in recent years.").

6. *See* Loop et al., *supra* note 3 (discussing the tactics that activists use).

settlement, standstill, or shareholder agreement, which may not advance the interests of the corporation or the larger shareholder base, but only those of the activist and the board.[7] These private deals often result in special benefits for the activist, primarily in the form of their representatives being appointed to the board outside of the normal shareholder election process. Through this benefit, they access the inner sanctum—the board of directors.

From the perspective of the boards, they receive a reprieve from the threat of a proxy fight or an attempt to force the sale of the company. The activist may make a variety of commitments, such as refraining from acquiring more shares, seeking governance or management changes except through the board, or running a proxy fight even after the activist's term on the board expires. When these private deals with activist investors occur, the movement to shareholder democracy has been hijacked and special interest governance triumphs. Because shareholder democracy has become an integral and growing part of a broader democratic process, undermining shareholder democracy results in undermining the democratic process in our society as a whole.

The thesis of this Article is that the development of shareholder democracy is good and that these special interest deals are not only bad for corporate governance and antithetical to the shareholder democracy movement, but also detrimental to the democratic values of our society. Recent activist activities thwart the traditional shareholder democracy movement and appropri-

7. Jordan Schoenfeld, *Shareholder-Manager Contracting in Public Companies,* HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 24, 2017), https://corpgov.law.harvard.edu/2017/10/24/shareholder-manager-contracting-in-public-companies (reviewing over 4400 binding bilateral shareholder agreements between 1996 and 2015). The numbers amassed by Schoenfeld also include situations that are not necessarily activist driven, such as joint venture agreements negotiated at arm's length. Nevertheless, the number of private deals with activists is substantial and increasing. *See* Lucian A. Bebchuk, Alon Brav, Wei Jiang & Thomas Keusch*, Dancing with Activists* (Columbia Bus. Sch. Research Paper No. 17-44; Harvard Law & Econ. Discussion Paper No. 906., 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2948869 ("While such settlements used to be rare, they now occur with significant frequency, and they have been attracting a great deal of media and practitioner attention."); Jason Frankl & Steven Balet, *The Rise of Settled Proxy Fights,* HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 22, 2017), https://corpgov.law.harvard.edu/2017/03/22/the-rise-of-settled-proxy-fights/, ("[C]ompanies have more frequently succumbed to these investors and at times, accepted unfavorable settlement terms instead of pushing forward and fighting through a proxy contest.").

ate special benefits to the activists and the narrow constituencies they represent. Even more disappointingly, but not surprisingly, corporate boards and management have become complicit in this process by facilitating these special interest deals. Limits must be placed on these special interest agreements. If regulated appropriately, shareholder democracy is on its way to becoming a strong political power that can counteract strong lobbies and corporate interests that are often not aligned with the societal values that many shareholders strive to advance.

Part I describes the development of shareholder democracy, starting from shareholder primacy to managerial capitalism through the hostile takeover era and into insulated managerialism. Part II then explores the recent resurgence of shareholder democracy, including monumental governance reforms and shareholder proxy access. The development of corporate democracy is now at a stage where it is important to insert the shareholder voice more directly in the governance process. This Part proposes creating shareholder advisory committees as an integral part of that process, either voluntarily by companies, or by way of regulatory mandate. Part III then explains the path taken by certain activist shareholders to avoid the regular corporate governance regime and instead lobby for individual or special interest preferences, primarily in the form of seats on the board of directors. This Part demonstrates how the resulting special agreements violate basic governance principles to the detriment of the vast majority of the corporation's other shareholders. Part IV proposes a means to simultaneously limit the special benefits of activist shareholders, and improve overall corporate democracy. Shareholders as a whole should have the right to determine if it is in the best interests for an agreement with an activist to be binding on the corporation. This is the only path by which shareholder democracy can continue to ascend in the publicly held corporation. This Article embodies the solution in a proposed model statute, which could be adopted by individual states or used as a template for shareholder proposals to change governance documents in individual companies.

I. THE WINDING PATH OF SHAREHOLDER INVOLVEMENT

A. FROM SHAREHOLDER PRIMACY TO MANAGERIAL CAPITALISM

The traditional shareholder primacy model[8] of a corporation derives from the concept that the shareholders are the owners of the corporation and, as such, are entitled to control it, determine its policies, and decide whether to make fundamental shifts in its corporate policy and practice. This system of corporate governance developed its essential attributes when "owners managed and managers owned."[9] Share ownership was not widely dispersed, there were few institutional investors, and the founders or local investors owned the shares of most corporations. That is, there was no divergence of interests between shareholders and management—the same people wore multiple hats. Other potential corporate constituencies took their place after the shareholders and only to the extent the shareholders determined, by contract or conscience, to be so bound.

The shareholder vote has traditionally been seen as the fundamental mechanism for shareholder control over corporate decisions.[10] Most fundamentally, shareholders vote to elect and remove directors.[11] In addition, fundamental corporate transactions require shareholder approval. For example, shareholders normally must vote on mergers,[12] dissolutions,[13] or sales of substantially all of a corporation's assets.[14] Within this model, however, the board of directors—as a management organ—is presumed to act as a surrogate for, and in the interests of, the shareholders.

The reign of the shareholder primacy mode of corporate governance was short-lived. By the beginning of the twentieth century, as the number of corporations grew and share ownership

8. *See* Robert J. Rhee, *A Legal Theory of Shareholder Primacy*, 102 MINN. L. REV. 1951, 1951 (2018) ("A foundational concept of corporate law and corporate governance is the principle of shareholder primacy.").

9. ALFRED D. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 9–10 (1977).

10. *See* Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CALIF. L. REV. 1071, 1073 (1990).

11. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(k) (2012). The board in turn designates officers to act as agents of the corporation. *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 1 (1976).

12. *See, e.g.*, DEL. CODE ANN. tit. 8, § 251(c).

13. *See, e.g.*, *id.* § 275.

14. *See, e.g.*, *id.* § 271.

dispersed,[15] a division between owners and non-owner managers existed.[16] As a result of the wide ownership dispersion, shareholders' ability to monitor corporate managers was significantly undermined[17] and the power to control a corporation became concentrated in the hands of managers, who owned little stock, if any.

Shareholder primacy fell on hard times. The separation of ownership and control gave rise to a period of managerial capitalism that was present for much of the twentieth century.[18] A director-centric model of corporate governance became the norm; boards had broad authority to exercise their business judgment on most matters[19] and shareholders seemingly had almost no incentive to become active investors.[20]

This director or management primacy norm also enhanced the likelihood that those controlling the corporation would lack an incentive to maximize efficiency and shareholder profitability due to pressures to diverge from the interests of shareholders.[21]

15. The number of shareholders during the 1920s increased from several hundred thousand before World War I to around eight million at the end of the 1920s. *See* HARVELL WELLS, SHAREHOLDER POWER IN AMERICA, 1800-2000: A SHORT HISTORY, RESEARCH HANDBOOK ON SHAREHOLDER POWER 1, 15 (Jennifer G. Hill & Randall S. Thomas eds., 2015). Also, the Glass-Steagall Act of 1933 prohibiting bank ownership of equity furthered corporate democratization and inhibited the development of institutional investors. *See* JANET DINE & MARIOS KOUTSIAS, THE NATURE OF CORPORATE GOVERNANCE 1, 135 (2013).

16. WELLS, *supra* note 15, at 19.

17. *See* George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 883 (1989) ("Each shareholder owned few shares and lacked the means or inclination to participate actively [in corporate matters].").

18. Alfred D. Chandler, Jr., *The Emergence of Managerial Capitalism*, 58 BUS. HIST. REV. 473 (1984) (discussing managerial capitalism).

19. ADAM O. EMMERICH ET AL., *USA*, *in* CORPORATE GOVERNANCE, JURISDICTIONAL COMPARISONS 439 (1st ed. 2013).

20. LISA M. FAIRFAX, SHAREHOLDER DEMOCRACY: A PRIMER ON SHAREHOLDER ACTIVISM AND PARTICIPATION 4 (2011).

21. Eighty years ago, Adolph Berle and Gardiner Means identified the issue as endemic to the publicly-held corporation, that the "separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge." ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932). Indeed, over 200 years ago, Adam Smith phrased the problem in terms of handling other people's money: "[t]he directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which . . . [they] watch over their own." 2 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 741 (R.H. Campbell, A.S. Skinner & W.B. Todd eds., Clarendon Press 1976). The law and economics

This divergence allowed managers to pursue their own self-interested agendas more aggressively within the corporate framework. Historically, corporations dealt with these conflict issues by implementing directors' and officers' fiduciary duties to the corporation and enforcing those duties by means of a shareholder derivative suit.[22]

With relatively secure positions, corporate management grew their businesses either organically or through horizontal and vertical acquisitions. As companies grew and matured through the 1960s and 1970s, however, these traditional forms of corporate growth became less available.[23] Expansion and diversification into unrelated lines of business then became the main drivers of merger and acquisition activity.[24] This was the era of the friendly corporate takeover, with the managements of both participating companies eager to consolidate.[25] Shareholders of both companies typically became shareholders of the combined entity. An unprecedented period of corporate merger and acquisition activity followed.[26] Corporate combinations of this type grew twelve-fold from 1960 through 1970.[27] This resulted in corporate empire building and the age of the conglomerate,[28] which is described in the next Section.

B. HOSTILE TAKEOVERS AND INSULATED MANAGERIALISM

The conglomerates of the 1960s and 1970s did not perform as well as their managers had hoped.[29] The ability to manage

movement, originating in the 1970s, coined the term "agency costs" to identify the same concern. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) ("If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal.").

22. *See* John Matheson, *Restoring the Promise of the Shareholder Derivative Suit*, 50 GA. L. REV. 327, 334–51 (2016).

23. Andrei Shleifer & Robert W. Vishny, *Takeovers in the '60s and the '80s: Evidence and Implications,* 12 STRATEGIC MGMT. J. (SPECIAL ISSUE) 51, 51–52 (1991).

24. *Id.* This wave of acquisition activity was also fueled by high corporate valuations, large cash flows, and active enforcement of antitrust laws chilling acquisition activity within the same industry or business sector.

25. *Id.*

26. *Id.*

27. *Id.*

28. Marina Martynova & Luc Renneboog, *A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand?*, 32 J. BANKING & FIN. 2148, 2153 fig. 1 (2008).

29. Gerald F. Davis et al., *The Decline and Fall of the Conglomerate Firm*

one form of business successfully does not necessarily carry over to managing disparate, unrelated businesses that comprise these conglomerates. Some companies voluntarily divested portions of their conglomerate businesses, yet others did not.[30] No matter the remedial steps that companies employed, when a company does not perform well, its shareholders are not happy.

Shareholders typically have two primary means to express displeasure with the operation of the corporations that they own. The first is the right to vote, particularly in the election of the board of directors.[31] As mentioned earlier, however, shareholders were widely dispersed at this time and did not effectively work together. The second means is the shareholders' right to dispose of their investment by selling their shares. To this end, shareholders can vote with their feet instead of voting their shares—this is referred to as the Wall Street Walk.[32] At the least, this conduct should evidence shareholder displeasure with management, which may constrain managerial abuses.[33]

For example, a shareholder may sell shares to a corporate raider[34] in a tender offer.[35] Such a sale might result in a change in control and the ouster of management, that is, a hostile takeover. Throughout the 1970s, and much of the 1980s, this market in corporate control acted as an important mechanism in moni-

in the 1980s: The Deinstitutionalization of an Organizational Form, 59 AM. SOC. REV. 547, 554 (1994).

30. Shleifer & Vishny, *supra* note 23, at 52–53.

31. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (Del. 1985) ("If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out.").

32. Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2645, 2646 (2009).

33. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1191, 1201 (1981).

34. Corporate raider is a pejorative term. As used here, corporate raider means a company or individual that follows a practice of making hostile takeover bids for companies, either to control their policies or to resell them for a profit.

35. *See* Joshua Kennon, *Understanding Tender Offers the Affect on Investors*, THE BALANCE, https://www.thebalance.com/what-is-a-tender-offer-4129430 (last updated July 13, 2018) ("A tender offer is a public offer, made by a person, business, or group, who wants to acquire a given amount of a particular security.").

toring corporate behavior and reversing much of the conglomeration on the 1960s and 1970s.[36] In these hostile takeovers, raiders, or bidders, made above-market purchase offers directly to company shareholders, going over the heads of the target company's management and board. Shareholders happily sold their shares for cash at a premium to the raider, or bidders, who purchased a controlling interest, unseated corporate managements from their thrones, and toppled empires.[37]

The hostile takeovers of the 1980s evidence the Wall Street Walk form of shareholder democracy.[38] Up to that time, the fragmented status of share ownership allowed corporate managements to build conglomerate empires and perpetuate themselves in board and officer positions.[39] Corporate raiders saw that these conglomerate companies could be more valuable if they were split up—the whole was less valuable than the sum of its parts.

The results were startling. While the 1960s and 1970s were days of amalgamation, the resulting massive enterprises were acquired and broken up.[40] In 1969, the height of the conglomeration wave, the total value of transactions was $23.7 billion; in 1981, during the hostile takeover and corporate break-up period, the value of transactions was almost four times greater, at $82.6 billion.[41] Over seventy percent of the assets acquired in hostile takeovers ended up, instead, in the hands of other companies in the same line of business as the assets acquired.[42]

Meanwhile, corporate managements, fearful of losing their companies and their jobs, fought back. They implemented an arsenal of defensive measures designed to deter or prevent hostile

36. John H. Matheson & Brent A. Olson, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425, 1435–38 (1991).

37. ROBERT SLATER, THE TITANS OF TAKEOVER 1–4 (1999).

38. See *infra* notes 184–90 and accompanying text for a discussion of whether shareholder activism resembles the hostile takeovers of the 1980s.

39. LESLIE A. WHITE, MODERN CAPITALIST CULTURE 388 (2008).

40. Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s*, 249 SCI. 745, 746 (1990) ("In the 1980s takeover wave, the so-called 'corporate raiders' and many leveraged buyout (LBO) specialists played the critical role of brokers. They acquired conglomerates, busted them up, and sold off most business segments to large corporations in the same businesses.").

41. SLATER, *supra* note 37, at 5. In 1984, the figure grew to $122 billion and in 1985 the number was $200 billion. Some of this activity was fueled by lessening of antitrust restrictions and enforcement in the Reagan administration. *Id.* at 5–7.

42. Shleifer & Vishny, *supra* note 23, at 54.

takeovers, ranging from golden parachutes, to stock repurchases, to poison pills.[43] Also in this era, the most famous cases of corporate law were decided.[44] In 1985 and 1986, the Delaware Supreme court decidedly took the corporate management's side in the hostile takeover battle. The Court approved company boards adopting defensive measures to fend off hostile takeovers,[45] specifically validated target companies adopting poison pills,[46] and allowed companies to keep defensive measures in place unless, and until, the board of directors of the company had made a decision to sell the company.[47]

At the same time, state legislatures, pressured by local companies and afraid that acquired businesses would be broken up or moved to other states, passed a panoply of antitakeover statutes. These included business combination acts, control share acquisition acts, and multi-constituency provisions.[48] Additionally, these legislatures adopted director exculpation statutes, which immunized corporate directors from breach of fiduciary duty claims based on the duty of care.[49]

The result of these combined corporate, judicial, and legislative measures created an impasse on the hostile takeover front. Managers became relatively protected from the direct threat of a hostile takeover and a period of insulated managerialism set in.[50] As detailed in the next Part, this stage of development did not last long.

43. John H. Matheson & Brent A. Olson*, Corporate Law and the Longterm Shareholder Model of Corporate Governance,* 76 MINN. L. REV. 1313, 1347–50 (1992).

44. The most famous corporate law case is *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), where the Court identified the standard that a board of directors must follow for its decision for the company to be acquired to have the protection of the business judgment rule.

45. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 946 (Del. 1985).

46. Moran v. Household Int'l., Inc., 500 A.2d. 1346 (Del. 1985).

47. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

48. Matheson & Olson, *supra* note 43, at 1338–46.

49. *Id.* at 1346–47.

50. *Id.* at 1337–53 (discussing insulated managerialism); *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1379 (Del. 1995) ("[T]he emergence of the 'poison pill' as an effective takeover device has resulted in such a remarkable transformation in the market for corporate control . . . .").

II. THE MODERN RESURGANCE OF SHAREHOLDER DEMOCRACY

Several trends coalesced in the 1990s, leading to a new wave of real shareholder democracy, one in which shareholders voiced their preferences by voting their shares instead of by selling them. The first was the stock ownership consolidation in the hands of institutional investors, giving them both the financial credibility and the incentive to play a more active role in corporate governance.[51]

The second trend was the ascendancy of proxy advisory firms. Proxy advisory firms provide research and recommendations as to how institutional investors should vote their shares in publicly held companies.[52] Traditionally, institutional investors generally had not taken an active role in corporate governance[53] and proxy advisory firms filled the void:

> [Proxy advisory firms'] rise to prominence began in the early 1980s in the wake of a U.S. Department of Labor's interpretation of the Employees Retirement Income Security Act (ERISA), which seemed to require a prudent trustee to vote the shares it held in portfolio companies. Failing to vote shares in its view implied wasting a portfolio asset and signaled that the fiduciary was breaching its duty of care. . . .
>
> Because many mutual funds compete by attempting to minimize overhead costs and thus have only small in-house staffs, these funds found it easier to outsource the voting decision to a third party. Proxy advisors—most notably ISS and Glass Lewis—developed to fill this role.[54]

51. By 1990 institutional investors owned a majority of the stock of all publicly traded companies in 1990, up from just twenty-three percent in 1955. MICHAEL J. RUBACH, INSTITUTIONAL SHAREHOLDER ACTIVISM: THE CHANGING FACE OF CORPORATE OWNERSHIP 8–9 (1999). Today that percentage is seventy percent. *See supra* note 3 and accompanying text; *see also* Luis A. Aguilar, SEC, *Institutional Investors: Power and Responsibility*, SEC (Apr. 19, 2013), https://www.sec.gov/news/speech/2013-spch041913laahtm ("Simply stated, institutional investors are dominant market players . . . .").

52. *See* TIMOTHY M. DOYLE, AM. COUNCIL FOR CAPITAL FORMATION, CONFLICTED ROLE OF PROXY ADVISORS 1 (May 2018), http://cdn.accf.org/wp-content/uploads/2018/05/ACCF-The-Conflicted-Role-of-Proxy-Advisor-FINAL.pdf (describing the role of proxy advisory firms).

53. That tradition is changing to some extent. *See* Abe M. Friedman, *BlackRock's Call for Companies to Deliver Financial & Social Value*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 6, 2018), https://corpgov.law.harvard.edu/2018/02/06/blackrocks-call-for-companies-to-deliver-financial-social-value.

54. John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance,* 41 J. CORP. L. 545, 557–58 (2016). Proxy advisory firms, however, have their own potential conflict of interest issues. *See* DOYLE, *supra* note 52.

The third trend was the revitalized utilization of Securities and Exchange Commission Rule 14a-8, titled "shareholder proposals" (the Rule).[55] The Rule has been called "the epicenter of the shareholder rights movement,"[56] and "a platform for communication and change."[57] The Rule allows shareholders to submit precatory proposals on the company proxy statement without incurring the expense of sending their own proxy statement.[58] It is a great means of communication for shareholders of public companies because the proxy statement reaches all of the shareholders whether or not the shareholder attends an annual meeting and votes on the matters in person. In fact, the majority of shareholders of large public companies do not attend the annual meeting and instead vote by proxy.[59] Therefore, shareholder proposals submitted pursuant to the Rule provide an efficient way to submit one's proposal for a vote to all shareholders of the company during the annual shareholder meeting.[60]

With such drastic changes in the ownership structure, guidance from proxy advisory firms, and access to companies' proxy statements, the role of shareholders in the corporate structure has changed as well. Shareholders, beginning as passive observers, have turned into active participants who shape the corporate governance and democracy in many positive ways. The following Sections illustrate several examples of this shareholder activism, influencing board structure, voting requirements, compensation, social policy disclosures, and proxy access.

A. NOTABLE SHAREHOLDER SUCCESSES

1. The Decline of Classified Boards

Classified boards provide that only a portion of a board's

55. 17 C.F.R. § 240.14a-8 (1998).

56. J. Robert Brown, Jr., *The Evolving Role of Rule 14A-8 in the Corporate Governance Process*, 93 DENV. L. REV. ONLINE 151, 151 (2016).

57. FAIRFAX, *supra* note 20, at 63. Of course, not all think that the shareholder proposal rule is a good thing. Some view it as an expensive process employed by a relatively few idiosyncratic shareholders. *See* David A. Katz & Laura A. McIntosh, *Shareholder Proposals in an Era of Reform*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 5, 2017), https://corpgov.law.harvard.edu/2017/12/05/shareholder-proposals-in-an-era-of-reform.

58. FAIRFAX, *supra* note 20, at 64.

59. *See* WILLIAM L. CARY & MELVIN ARON EISENBERG, CORPORATIONS: CASES AND MATERIALS 244, 330 (David L. Shapiro et al. eds., 7th ed. 1997) ("Proxy voting is the dominant mode of shareholder decision making in publicly held corporations.").

60. *Id.*

members will be up for election in any given year. Typically, one-third of the directors are elected each year, and each director serves a three-year term. As with the staggered terms for elected officials in the U.S. Senate, this structure allows for continuity since only one third of the directors are replaced in any given year.

Although scholars have debated whether classified boards are good[61] or bad,[62] shareholders view classified boards as an entrenchment device that makes it difficult to replace the entire board in a single year.[63] Shareholders have been submitting proposals to declassify boards since the 1980s.[64] In 2000, such proposals started gaining more than fifty percent shareholder support, a passing vote.[65] Since then, proposals to declassify corporate boards have been presented more than 800 times at more than 500 companies.[66]

What has been the result? While most S&P 500 companies had classified boards in 2000, 89.1% of S&P 500 companies had

61. *See, e.g.*, K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67, 67 (2016) (arguing that staggered boards are associated with an increased firm value); Guhan Subramanian, *Delaware's Choice*, 39 DEL. J. CORP. L. 1, 1 (HARV. JOHN M. OLIN DISCUSSION PAPER SERIES NO. 828) (2015) (arguing that de-staggering of boards of directors was a mistake, which resulted in short-termism in corporate boardrooms); Martin Lipton & Theodore Mirvis, *Harvard's Shareholder Rights Project Is Wrong*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 23, 2012), https://corpgov.law.harvard.edu/2012/03/23/harvards-shareholder-rights-project-is-wrong (arguing that a staggered board is an important tool in fending off inadequate bids that harm companies focusing on long-term value creation and that, to the contrary, the idea that declassifying boards will help long-term value creation is not supported by any evidence and thus must be rejected).

62. *See, e.g.*, Lucia A. Bebchuck, *The Myth That Insulating Boards Serves Long-term Value*, 113 COLUM. L. REV. 1637, 1637 (2013) (finding no supporting evidence that boards insulation at current (or higher) levels serves long-term interests of a company and its shareholders); Charles C.Y. Wang, *How Do Staggered Boards Affect Shareholder Value? Evidence from a Natural Experiment*, 110 J. FIN. ECON. 627 (2013) (finding that staggered boards bring about reduced shareholder value).

63. FAIRFAX, *supra* note 20, at 80.

64. *The Latest in Governance Reform – Proxy Access*, INSTITUTIONAL SHAREHOLDER SERVICES (ISS), https://www.issgovernance.com/the-latest-in-governance-reform-proxy-access ("[T]he campaign's early years (in the late-1980s and 1990s) moved in slow motion as staggered board repeals – largely prodded by gadflies' shareholder proposals during this period . . . .").

65. *Id.*

66. *Id.* ("Voting Analytics data show that investors have cast their votes on 811 repeal classified board shareholder proposals at 511 unique firms since the year 2000. Average support over this period is 66.7 percent of the votes cast. Nearly 70 percent of these proposals received majority votes; 62 percent are considered to have passed.").

declassified boards in 2015.[67] Whether one believes that staggered boards are good or bad for corporate governance, the message is clear. Shareholders are exercising a clearer and stronger voice in the companies they own. Management is listening. Shareholder democracy exists, at least in this arena.

2. Majority Voting Movement

Electing the board of directors is maybe the most fundamental shareholder right. Historically, directors were elected by a plurality vote—that is, the candidate with the most votes wins, even if that vote is not a majority of the votes that are cast.[68] Under this method, although shareholders could withhold their vote for a director, they could not vote against that director.[69] Thus, in an uncontested election, every nominee elected by a plurality wins his or her seat upon receiving just one "for" vote.[70]

Shareholders, however, have balked at that standard,[71] particularly in uncontested elections.[72] Shareholders made proposals that would require companies to adopt majority voting, thereby requiring uncontested board nominees to receive more

67. *Fewer Classified Boards Could Mean Higher Director Turnover*, EQUILAR BLOG (Mar. 7, 2016), https://www.equilar.com/blogs/84-fewer-classified-boards.html. ("About 58.5% of Russell 3000 companies had a declassified board in 2015, up from 52.5% in 2011.").

68. *See, e.g.*, DEL. CODE ANN. tit. 8, § 216(3) (2018) ("Directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors . . . .").

69. Plurality voting allows for election of a nominee who receives the most "for" votes until all board seats are filled. COUNCIL OF INSTITUTIONAL INV'RS, FAQ: MAJORITY VOTING FOR DIRECTORS 1–2 [hereinafter MAJORITY VOTING REPORT], https://www.cii.org/files/issues_and_advocacy/board_accountability/majority_voting_directors/CII%20Majority%20Voting%20FAQ%201-4-17.pdf (last visited Jan. 29, 2019). Almost all companies give shareholders an option on the ballot to "withhold" their vote. *Id.* However, such withheld votes do not have any effect. *Id.*

70. Moreover, a director can be elected with a single "for" vote over the opposition of all other voting shares. David A. Katz & Laura A. McIntosh, *Corporate Governance: Majority Election of Directors*,

N.Y. L.J. (2005). The Council of Institutional Investors (CII) calls it a "rubber stamp" process to entrench boards and to elect directors who lack support of shareholders representing a majority. MAJORITY VOTING REPORT, *supra*, at 2.

71. Beginning in 2005, shareholders started to insist on changes in the voting standard. *See* Stephen J. Choi et al., *Does Majority Voting Improve Board Accountability?*, 83 U. CHI. L. REV. 1119, 1119, 1125 (2016) (detailing a study covering around 65,000 of uncontested elections between 2007 and 2013).

72. Randall S. Thomas & Patrick C. Tricker, *Shareholder Voting in Proxy Contests for Corporate Control, Uncontested Director Elections and Management Proposals: A Review of the Empirical Literature*, 70 OKLA. L. REV. 9, 49 (2017) ("The overwhelming majority of corporate elections are uncontested.").

"for" votes than "against" votes in order to be elected or re-elected.[73] The shift from plurality to majority voting has been recognized as one of the "most popular and successful governance reforms."[74] In 2004, shareholders submitted only twelve proposals to adopt majority voting.[75] In 2005, the number of proposals increased to eighty-nine and this became the most common form of proposal.[76] In 2006, more than 150 majority vote proposals were submitted.[77]

These proposals were effective. In 2005, only nine of all S&P 100 companies used majority voting in director elections.[78] However, by 2017, ninety percent of S&P 500 companies had adopted some type of majority voting.[79] Companies that moved away from plurality voting generally adopted one of three types of director election regimes: (1) "plurality plus;"[80] (2) majority voting with board-rejectable resignation;[81] (3) and consequential majority voting.[82] Whatever the format adopted, shareholders once again demonstrated that they are able to ensure they would be heard.

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73. *Majority Voting for Directors,* COUNCIL INSTITUTIONAL INV., http://www.cii.org/majority_voting_directors (last visited Jan. 29, 2019).

74. Choi et al., *supra* note 71, at 1119.

75. FAIRFAX, *supra* note 20, at 89.

76. *Id.* at 88–89.

77. *Id.* at 89.

78. Choi et al., *supra* note 71, at 1121.

79. COUNCIL OF INSTITUTIONAL INV., *supra* note 73.

80. In response to a growing investor dissatisfaction with the plurality voting, since 2004 some companies have adopted plurality plus voting regime. MAJORITY VOTING REPORT, *supra* note 69, at 2. Under this approach, a majority-opposed director must tender a resignation to the board. *Id.* However, a director who does not receive majority support is still elected for another term, subject to the board's acceptance of his or her resignation. *Id.* CII recognizes this approach to be in the right direction but admits that it is not the best approach to elect uncontested directors. *Id.*

81. Under the majority voting with board-rejectable resignation approach, uncontested nominees must receive more "for" votes than "against" votes to be elected. *Id.* Majority opposed nominees will not be elected under this approach. *Id.* However, the majority of companies couple the standard with a resignation requirement for defeated directors. *Id.* Under that requirement, the board retains the authority over whether the defeated director departs or stays. *Id.* Thus, it is an imperfect voting regime that preserves the board's power over the board's composition. *Id.*

82. Pursuant to the consequential majority voting approach, an uncontested nominee must receive more "for" votes than "against" to be elected. *Id.* Additionally, there is a reasonable point at which an unelected director may no longer serve on the board. *Id.*

The powerful shareholder movement toward a majority voting regime fostered legislative and regulatory changes. Prior to 2006, nearly every state corporate code provided for plurality voting as the default rule for director elections.[83] Subsequently, a number of states amended their corporate code to provide for majority voting as the default rule.[84] In 2006, Delaware amended its corporate code prohibiting boards of directors from repealing shareholder-adopted bylaws providing for majority voting for the election of directors.[85] In 2009, the SEC effectively amended NYSE Rule 452, curtailing brokers' ability to vote without instruction from shareholders in uncontested elections by excluding such elections from its "routine" matters definition.[86] This means that the shareholders themselves would have to vote. In 2010, the Dodd-Frank Act strengthened that change by applying it to all national exchanges as well as advisory votes on compensation and other matters the SEC considers significant.[87] Thus, a series of shareholder-driven developments resulted in a wholesale change in the shareholder voting process.

3. Say on Pay

Say-on-pay rules allow shareholders to weigh in on the compensation of the highest-ranking corporate executives in their company. These rules originated in the shareholder proposal proxy process.[88] In 1992, the SEC expanded the topics suitable for shareholder proposals to include shareholder proposals on executive compensation.[89] These new 1992 rules were intended to

83. Robert Profusek et al., *Majority Voting for Directors*, JONES DAY (Oct. 31, 2006), https://www.jonesday.com/Majority-Voting-for-Directors-10-31-2006 ("Plurality voting in the election of directors is the default standard in most state corporate statutes, including Delaware's, as well as under the Model Act.").

84. CLAUDIA H. ALLEN, STUDY OF MAJORITY VOTING IN DIRECTOR ELECTIONS v–vi (2007), https://www.kattenlaw.com/Files/45102_FINAL%20%20MAJORITY%20VOTE%20SURVEY.pdf.

85. *See, e.g.*, DEL. CODE ANN. tit. 8, § 216 (2018) ("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.").

86. Exchange Act Release No. 34-60215 (July 1, 2009).

87. Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78f(b) (2012).

88. Stephani A. Mason et al., *Say-on-Pay: Is Anybody Listening?* 20 MULTINATIONAL FIN. J. 273, 285 (2016).

89. *Id.* Stock options were increasingly used to incentivize CEOs' performance. As a result, CEO pay significantly increased. Fabrizio Ferri, *Say on Pay*, RESEARCH HANDBOOK ON SHAREHOLDER POWER 319, 320 (Jennifer G. Hill &

shed more light on and to address growing concerns about executive compensation and performance.[90]

Starting in 2004, executive compensation became a dominant topic for shareholder proposals.[91] In 2009, shareholders submitted more than 200 pay-related proposals.[92] By 2010, the say-on-pay shareholder proposals calling for an advisory vote on executive compensation were the center of attention and the dominant type of shareholder proposal that was submitted.[93]

As a result of this strong support for the say-on-pay proposals and the financial crisis of 2007–2008,[94] the federal government decided to mandate say-on-pay rules.[95] In 2009, companies receiving funding under the Troubled Asset Relief Program were mandated to hold an annual shareholder say-on-pay vote.[96] Further, the Dodd-Frank Act in 2010, and the SEC rules implementing the Dodd-Frank Act in 2011, mandated that public companies provide shareholders with an advisory say-on-pay vote at least every three years,[97] a non-binding vote on the frequency of a say-on-pay vote,[98] and an advisory vote on compensation ar-

Randall S. Thomas eds., 2015).

90. Marilyn F. Johnson et al., *An Empirical Analysis of the SEC's 1992 Proxy Reforms on Executive Compensation* 1, 4–5 (Stanford Univ. Graduate Sch. of Bus., Research Paper No. 1679, 2001). The new SEC rules required expanded proxy statement disclosures and allowed shareholder proposals on executive compensation. *Id.* The intent was to create a mechanism for shareholders to express their dissatisfaction with the compensation policies disclosed in the proxy statement. *Id.*

91. FAIRFAX, *supra* note 20, at 78.

92. *Id.*

93. *Id.*

94. Ferri, *supra* note 89, at 321.

95. FAIRFAX, *supra* note 20, at 79.

96. *Id.* Around 400 companies were required to hold say-on-pay votes. *Id.*

97. *Id.* The SEC rules required that companies provide disclosure in the annual meeting proxy statement, including whether the vote is binding. *SEC Adopts Rules for Say-on-Pay and Golden Parachute as Required under Dodd-Frank Act*, SEC (Jan. 25, 2011), https://www.sec.gov/news/press/2011/2011-25.htm [hereinafter *Say-on-Pay Release*]. Also, an additional disclosure is required in the Compensation Discussion and Analysis (CD&A) regarding whether and how companies have considered the results of the most recent say-on-pay vote. *Id.*

98. FAIRFAX, *supra* note 20, at 79. The frequency vote is required at least once every six years. *Say-on-Pay Release*, *supra* note 97. The companies must disclose the frequency in the annual meeting proxy statement. *Id.* To provide shareholders with the information on how frequent they may vote on executive compensation, the SEC mandated that a company file From 8-K no later than 150 calendar days after the date of the annual meeting in which the vote took place, and no later than 60 calendar days before the deadline for submission of

rangements in connection with mergers (i.e. "golden parachutes").[99] For the first time shareholders of a company could directly validate or criticize the executive compensation arrangements that the company's board provided to top-level management. A stronger validation of the power of pure shareholder democracy, with the ability to move both corporations and legislatures, is hard to find.[100]

4. Environmental and Social Proposals

Shareholders have presented environmental and social proposals with increasing frequency. For the past few years, proposals calling for companies to disclose their political participation and political contributions have most frequently been brought to a vote.[101] Climate change proposals asking companies to disclose their business risks related to climate change are at historically high levels.[102] Shareholders have asked companies to introduce policies to enhance board and employee diversity.[103]

Rule 14a-8 shareholder proposals for the subsequent meeting. *Id.* The form must disclose the company's decision regarding the frequency of the say-on-pay vote. *Id.*

99. The "golden parachute" disclosure is also required in connection with a number of transactions, including going-private transactions and third-party tender offers to ensure the availability of the information for shareholders without regard to the structure of the transaction. *Id.* In August of 2015, the SEC adopted final rules implementing the pay ratio disclosure mandate of Section 953(b) of the Dodd-Frank Act. Under the final rule, companies must disclose "the median of the annual total compensation of all employees of the [company] . . . other than the CEO . . . the annual total compensation of the CEO . . . and the ratio of these two amounts." Ronald O. Mueller et al., *SEC Issues Significant Guidance on Pay Ratio Rules*, 31 INSIGHTS CORP. & SEC. L. ADVISER 3 (2017). The disclosure will be required in the company's 2018 proxy statement. *Id.*

100. *See also* Aguilar, *supra* note 51 ("'[S]ay-on-pay' is an opportunity for shareholder engagement — providing investors with a forum to discuss compensation and other corporate governance issues with management, and enhancing the ability of institutional investors, in particular, to have their voices heard.").

101. Thomas Singer, *Environmental and Social Proposals in the 2017 Proxy Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 26, 2017), https://corpgov.law.harvard.edu/2017/10/26/environmental-and-social-proposals-in-the-2017-proxy-season.

102. *Id.*

103. *Id.* "Board diversity—in particular, the inclusion of women on boards—received significant attention in 2017, including through institutional investor policies, shareholder proposals, company proxy disclosure and non-binding state legislative resolutions. This is likely to be a topic of continued focus in 2018." SULLIVAN & CROMWELL, LLP, 2017 PROXY ACCESS SEASON REVIEW (2017), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_2017_Proxy_Season_Review.pdf.

Since 2015 (when the first gender pay gap proposal was introduced), gender pay gap proposals have become another of the most frequently voted environmental and social topics during the proxy season.[104]

Through their pursuit of environmental and social proposals, shareholders have wielded significant influence on U.S. companies' environmental and social behavior.[105] A study analyzing around 2,665 shareholder proposals submitted between 1997 and 2012 discovered that when shareholders file a proposal on an environmental, social, or governance issue, the company's performance with respect to that issue improves.[106] When faced with such proposals, managers invest more resources to address these issues including diversity, energy efficiency, water consumption, and product safety.[107] Today, this trend continues.[108] Shareholders are actively submitting proposals and setting a high social conscience standard for corporations.[109]

104. Singer, *supra* note 101. Additionally, proposals on Holy Land Principles (calling for American companies conducting business in Palestine-Israel to practice fair employment) have been increasingly introduced by shareholders this proxy season. *Id.* Finally, proposals calling companies to publish sustainability reports continue to gain traction. *Id.*

105. Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 218 (2018); *see* FAIRFAX, *supra* note 20, at 82 (noting that the "success" of shareholder proposals depends on their ability to prompt corporations to dialogue rather than to garner majority support); *see also* YAFIT COHN, SIMPSON THACHER, CLIMATE CHANGE, SUSTAINABILITY AND OTHER ENVIRONMENTAL PROPOSALS 2 (2016), http://www.stblaw.com/docs/default-source/memos/firmmemo_08_08_16_environmental-proposals.pdf. ("[Environmental proposals] appear to be getting more traction, as companies seem to be more inclined to negotiate with proponents as compared to previous years.").

106. George Serafeim, *The Fastest-Growing Cause for Shareholders Is Sustainability*, HARV. BUS. REV. (July 12, 2016), https://hbr.org/2016/07/the-fastest-growing-cause-for-shareholders-is-sustainability.

107. *Id.*

108. During the 2006–2014 proxy period, Proxy Monitor reported thirty-nine percent of proposals relating to process-based corporate-governance concerns—such as board structure and the rules for electing directors and taking other shareholder actions; thirty-nine percent of proposals were on social policies; and twenty-two percent of proposals involved executive compensation. James R. Copland, *Recent Legal and Regulatory Changes Create Uncertain Landscape for 2015 Proxy Season: Proxy Access on the Agenda*, PROXY MONITOR, http://www.proxymonitor.org/Forms/pmr_10.aspx (last visited Jan. 29, 2019). During 2017 proxy season, thirty-six percent of proposals were on corporate governance, fifty-six percent—on social policy, and eight percent—on executive compensation. James R. Copland & Margaret M. O'Keefe, *Proxy Monitor 2017: Season Review*, PROXY MONITOR, http://www.proxymonitor.org/Forms/pmr_15.aspx (last visited Jan. 29, 2019).

109. Christopher P. Skroupa, *2017 and Beyond—Major Trends Shaping Shareholder Activism*, FORBES (Oct. 31, 2017), https://www.forbes.com/sites/

5. Proxy Access

Shareholders have the legal right to elect directors.[110] However, each publicly held company has a nominating committee solely made up of board members that recommends a slate of director candidates to the shareholders.[111] The company then releases a proxy statement recommending only those candidates that the board itself nominates for election to the board.[112] Individual shareholders generally have neither the inclination nor the means to wage a proxy contest, in which it would propose a competing slate of directors for election. As a practical matter, in the absence of a hostile proxy fight, the shareholders automatically elect the directors so nominated.[113] Therefore, the boards of directors of publicly held corporations are self-perpetuating.[114]

Consequently, "proxy access" has been deemed a significant achievement of shareholder democracy.[115] In its purest form, proxy access allows shareholders to place their own nominees on

christopherskroupa/2017/10/31/2017-and-beyond-major-trends-shaping-shareholder-activism/#668d4c8e15e7. Institutional shareholders "have deployed $45 billion in new campaigns year to date, nearly double the amount for all of 2016." *Id.* The "big three" (Vanguard, State Street and BlackRock) set a strategy that indicates their concern for the environmental, social, and governance (ESG) practices of their portfolio companies. *Id.*

110. *See, e.g.*, DEL. CODE ANN. tit. 8, § 216(3) (2018) ("Directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors". . . .").

111. *See, e.g.*, LISTED COMPANY MANUAL 303A.04 (N. Y. STOCK EXCHANGE 2013); LISTING RULE 5605(e) (NASDAQ 2006).

112. MAJORITY VOTING REPORT, *supra* note 69, at 2 ("It's a 'rubber stamp' process that entrenches boards and, in rare instances, elects directors who lack the confidence of shareholders representing a majority.").

113. Robert C. Pozen, *Shareholders Get a Louder Voice*, BROOKINGS (Mar. 3, 2015), https://www.brookings.edu/opinions/shareholders-get-a-louder-voice (arguing that although shareholders may nominate directors, the cost is so high for public companies that it effectively prevents most shareholders from making nominations).

114. Michael E. Murphy, *The Nominating Process for Corporate Boards of Directors: A Decision-Making Analysis,* 5 BERKELEY BUS. L.J. 131, 132 (2008) ("The nominating procedure for electing directors to the corporate board has turned the formal legal structure of corporate governance on its head. The shareholders may be equity owners of the corporation, but when they are presented with an unopposed slate of directorial candidates, without having practical means of nominating their own candidates, it is clear that management effectively controls the corporate ballot.").

115. *See* Karey Wutkowski, *SEC to Look Outside Ballot on Proxy Access*, REUTERS (Jan. 4, 2008), https://www.reuters.com/article/us-column-lifting/sec-to-look-outside-ballot-on-proxy-access-idUSN1741224720080104 (noting that proxy access has been considered a "holy grail" of shareholder democracy).

the company's proxy ballot, with information about those nominees included in the company's proxy statement.[116] This avoids the cost required for the shareholder to produce a separate set of proxy materials.[117] These shareholder nominees for board positions would appear as alternatives to the slate of directors posed by the board itself.[118]

Proxy access went through several stages of development before it reached its current form. The SEC staff first proposed a pure form of proxy access in 1942.[119] This form would have provided that "minority stockholders be given an opportunity to use the management's proxy material in support of their own nominees for directorships[,]" and required that "stockholders be permitted to use the management's proxy statement to canvass stockholders generally for the election of their own nominees for directorships, as well as for the nominees of the management."[120] A shareholder was not required to hold a certain amount of stock or to have held stock for any certain period of time. The proposal was not adopted,[121] and the SEC's attempts to revisit the issue in 1982, 2003, and 2007 also resulted in no action.[122]

The SEC made its most recent attempt to tackle the proxy access issue in 2010. The SEC adopted a new Rule 14a-11, mandating proxy access for all public corporations, and allowing certain shareholders to nominate up to three persons for election to a corporation's board.[123] Under the Rule 14a-11, "a nominating shareholder or group will be required to satisfy an ownership

116. Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1260 (2009).

117. *Id.* at 1267–68.

118. *Proxy Access*, COUNCIL INSTITUTIONAL INV. https://www.cii.org/proxy_access [hereinafter *Proxy Access*].

119. FAIRFAX, *supra* note 20, at 65.

120. DIV. OF CORP. FIN., SEC, STAFF REPORT: REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS 2 (2003), https://www.sec.gov/news/studies/proxyreport.pdf.

121. *Id.* "The Commission did not provide an explanation for its determination, stating simply that, 'a number of the suggestions proposed by the staff were not adopted,' including the suggestion related to shareholder access to the company's proxy material." *Id.* (quoting Exchange Act Release No. 34-3347 (Dec. 18, 1942)).

122. *See* FAIRFAX, *supra* note 20, at 132–34.

123. *See* Facilitating Shareholder Director Nominations, Exchange Act Release No. 33-9136, 75 Fed. Reg. 56,668, 56,773–93 (Sept. 16, 2010) (adopting changes to the federal proxy rules to permit direct shareholder nomination of directors).

threshold of at least 3% of the voting power of the company's securities" and "will be required to have held the qualifying amount of securities continuously for at least three years."[124]

The new rule caused a lengthy debate over whether and to what extent shareholders should have access to companies' proxy statements.[125] However, the debate was short-lived. In July 2011, the U. S. Court of Appeals for the D.C. Circuit vacated Rule 14a-11.[126] The court reasoned that the SEC was "arbitrary and capricious" in adopting the rule and violated the Administrative Procedure Act by failing to conduct an adequate cost/benefit analysis in adopting Rule 14a-11.[127]

Although the attempt to create a federal rule of proxy access applicable to all publicly held corporations failed, real shareholder democracy began to kick in. Institutional investors and proxy advisors began to pressure corporations into changing their bylaws to permit proxy access, allowing shareholders to nominate a minority slate of directors for possible election at the annual shareholder meeting by means of the corporation's proxy statement and proxy card.[128] Generally, these proposals provided proxy access to shareholders who held at least three percent of outstanding shares for at least three years.[129] This movement became known as proxy access by private ordering.[130] The SEC supported this movement by adopting changes to Rule 14a-8(i)(8),[131] which previously allowed a company to exclude proposals that related to nomination or election of directors, or procedures for such nominations or elections, from the proxy materials.[132] As amended, Rule 14a-8(i)(8) does not allow companies

124. *Id.* at 23–24.

125. *The Annual Meeting of Shareholders*, 12-6th Corp. Practice Portfolio Series (BNA) ch. 4, § E 2 (2018).

126. *See* Bus. Roundtable Inc. v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

127. *Id.* at 1154. The SEC decided not to seek a rehearing or appeal of the decision.

128. *Proxy Access*, *supra* note 118. Proxy access also allows a nominating shareholder to provide a brief description of his or her nominee in the company's proxy statement. *Id.*

129. *Id.*; *see also* COUNCIL OF INSTITUTIONAL INV'RS, PROXY ACCESS: BEST PRACTICES 2017, at 4 (2017), http://www.cii.org/files/publicaitons/misc/Proxy_Access_2017_Final.pdf (describing best practices in proxy access). Not all of the three percent had to be owned by one shareholder. Shareholders could pool their shares to meet the ownership requirement and nominate candidates. *Id.*

130. COUNCIL OF INSTITUTIONAL INV'RS, PROXY ACCESS BY PRIVATE ORDERING 2 (2017) [hereinafter PRIVATE ORDERING], http://www.cii.org/files/publications/misc/02_02_17_proxy_access_private_ordering_final.pdf.

131. Shareholder Proposals, 17 C.F.R. § 240.14a-8 (2018).

132. Facilitating Shareholder Director Nominations, 76 Fed. Reg. 58,100

to exclude shareholder proposals to amend, or request that the companies consider amending, governing documents to provide for procedures for shareholder director nominations.[133]

Initially, companies were slow to amend their bylaws to permit proxy access.[134] However, in November 2014, the Comptroller of the City of New York, acting on behalf of the New York City pension funds, instituted a campaign for the 2015 proxy season, submitting seventy-five proxy access proposals to different companies.[135] This initiative—the Boardroom Accountability Project—greatly accelerated the public companies' adoption of proxy access.[136] In 2014, only fifteen shareholder proxy access proposals went to a vote, and only four passed.[137] In both 2015 and 2016, more than eighty such proposals went to a vote, and shareholders approved more than half.[138]

Faced with this evidence of substantial shareholder support, many companies "voluntarily" adopted this form of proxy access. As of January 2018, sixty-five percent of S&P 500 companies have adopted proxy access.[139] This success, together with the other shareholder initiatives discussed in this Section, show significant instances of shareholders' impact on publicly held companies. The next step, addressed in Part I.B, is to institutionalize the shareholders' role in the ongoing governance process.

B. IMPROVING SHAREHOLDER DEMOCRACY: SHAREHOLDER ADVISORY COMMITTEES

> The time has come for a new model of shareholder engagement—one that strengthens and deepens communication between shareholders and the companies that they own. If engagement is to be meaningful and productive—if we collectively are going to focus on benefitting

(Sept. 20, 2011).

133. SCOTT LESMES, MORRISON & FOERSTER, LLP, FREQUENTLY ASKED QUESTIONS ABOUT SHAREHOLDER PROPOSALS AND PROXY ACCESS 16 (2017), https://media2.mofo.com/documents/frequently-asked-questions-about-shareholder-proposals-and-proxy-access.pdf. The proposal could not conflict with Rule 14a-11 and could not otherwise be excludable under some other procedural or substantive grounds. *Id.*

134. *Id.*

135. PRIVATE ORDERING, *supra* note 130, at 2; *Boardroom Accountability Project*, N. Y. C. COMPTROLLER, https://comptroller.nyc.gov/services/financial-matters/boardroom-accountability-project/overview (last visited Jan. 30, 2019).

136. N. Y. C. COMPTROLLER, *supra* note 135.

137. PRIVATE ORDERING, *supra* note 130, at 2.

138. *Id.*

139. John Jenkins, *Proxy Access: Game Over?*, CORP. COUNS. (Feb. 14, 2018), https://www.thecorporatecounsel.net/blog/2018/02/proxy-access-gameover.html.

> shareholders instead of wasting time and money in proxy fights—then engagement needs to be a year-round conversation about improving long-term value."[140]

The key to the continued growth of shareholder democracy, as a corporate governance mechanism and as a subspecies of the democratic process as a whole, is to provide the means by which shareholders may be heard, and their voices may be given the maximum effect.[141] Shareholders, on the one hand, and the board and management, on the other, are in a corporate governance relationship. Effective communication is key to any healthy relationship. By the nature of their role in directing company policy and operations, management and the board have ongoing input.[142] The shareholders, however, do not.[143] Thus, a publicly held corporation must find ways to enhance shareholder engagement in order to provide the information that both shareholders and management need to function effectively.[144]

Typically, shareholder engagement is a perfunctory matter that takes place only during, or in connection with, certain required or scheduled events, such as annual meetings, earnings releases, analysts' calls, or public announcements.[145] This is not effective communication and engagement. Recently, and especially in light of the increasing frequency of activist attacks, com-

140. Larry Fink, BlackRock Inc, *A Sense of Purpose*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 17, 2018), https://corpgov.law.harvard.edu/2018/01/17/a-sense-of-purpose.

141. James D.C. Barrall, *Building Relationships with Your Shareholders Through Effective Communication*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 13, 2012), https://corpgov.law.harvard.edu/2012/11/13/building-relationships-with-your-shareholders-through-effective-communication ("Over the last four decades, a competing paradigm of shareholder democracy has emerged. Today, shareholders demand increasing input on decisions that, under the old paradigm, unquestionably would have remained in the purview of the board's or management's business judgment.").

142. The board of directors has the statutory authority to manage the business and affairs of the corporation, while the management officers are chosen by the board and report to it. *See* DEL. CODE ANN. tit. 8, §§ 141(a), 142 (2018).

143. *But see id.* § 351 (management by stockholders in a statutory "close corporation" if elected under Delaare law).

144. For institutional investors to comply with their own fiduciary duties to invest prudently, they must have the information necessary to evaluate the performance of the companies in which they invest and the directors to whom they have delegated managerial responsibility.

145. TARUN MEHTA, ISS CORP. SERVS., SHAREHOLDER ENGAGEMENT: MAXIMIZING THE SHAREHOLDER RELATIONSHIP 1 (2013), https://www.issgovernance.com/file/publications/MaximizingTheShareholderRelationshipVol_13.3.pdf.

panies are considering more active forms of shareholder engagement.[146] Suggestions include increasing the frequency of communications, providing shareholders with direct access to board members or chairs of board committees, and expanding methods to reach shareholders beyond those that are legally required.[147]

The changing nature of the equity markets makes the necessity for more direct, consistent, and routinized engagement imperative. More than thirty percent of the market value of equity assets under management are held in passive investment vehicles such as index funds, electronically traded funds, and some mutual funds.[148] These investors are long-term owners and, because of that fact, have a greater interest in the governance of the firms they own.[149] As these investors hold a larger percentage of shares than other shareholders, their voices may be heard, but there is no effective process for them to be heard on a regular basis.

146. Tom Johnson, *Shareholder Engagement: An Evolving Landscape*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 9, 2017), https://corpgov.law.harvard.edu/2017/03/09/shareholder-engagement-an-evolving-landscape.

147. MEHTA, *supra* note 145, at 2–5; Paula Loop, *Engagement: New Imperatives,* HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 30, 2016), https://corpgov.law.harvard.edu/2016/06/30/engagement-new-imperatives.

There are even firms that specialize in advising companies on shareholder engagement. *See, e.g.*, *Corporate Governance and Shareholder Engagement,* COOLEY, https://www.cooley.com/services/practice/corporate-governance-shareholder-engagement (last visited Jan. 30, 2019).

148. Ed Batts, *BlackRock Talks . . . and U.S. Companies Must Listen*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 13, 2018), https://corpgov.law.harvard.edu/2018/02/13/blackrock-talks-and-u-s-companies-must-listen. Passive investing is an investing strategy that tracks a market-weighted index or portfolio.

149. *See* Fink, *supra* note 140 ("Globally, investors' increasing use of index funds is driving a transformation in BlackRock's fiduciary responsibility and the wider landscape of corporate governance. In the $1.7 trillion in active funds we manage, BlackRock can choose to sell the securities of a company if we are doubtful about its strategic direction or long-term growth. In managing our index funds, however, BlackRock cannot express its disapproval by selling the company's securities as long as that company remains in the relevant index. As a result, our responsibility to engage and vote is more important than ever. In this sense, index investors are the ultimate long-term investors—providing patient capital for companies to grow and prosper."). Recently several of the largest institutional investors have combined to form the Investor Stewardship Group (ISG) and have promulgated a Framework for U.S. Stewardship and Governance, which went into effect on January 1, 2018. *See* INVESTOR STEWARDSHIP GROUP, https://isgframework.org (last visited Jan. 30, 2019). ISG, however, does not have a mechanism for having its voice heard, as is proposed herein through the shareholder advisory committee.

If shareholder engagement and shareholder democracy are to take a leap forward, they need to be part of a formal process in which shareholders participate with companies and start to work together in more proactive ways. As proposed in this Article, the time has come to institutionalize shareholder engagement through the creation of shareholder advisory committees (SACs). The adoption of SACs can fundamentally improve the shareholder-management relationship.

While the creation, structure, and scope of these committees can vary, the principle point is that SACs should become a fundamental part of the corporate governance framework. At a minimum, the committee would regularly meet to receive information from the board and management and to provide feedback and advice to the board and management. At a maximum, the SACs could be tasked with nominating candidates for election to the board, setting board compensation, approving of settlement of shareholder derivative suits, and providing input on corporate financings, acquisitions, and other fundamental actions.[150] Whatever the scope of the SACs' activity, the first step is to institutionalize its role as a communication conduit from the shareholders as a whole to the board and management.

There are various models by which a shareholder advisory committee could be created and function. A starting point might be the shareholder bankruptcy committees permitted under Chapter 11 of the Bankruptcy Code.[151] The Bankruptcy Code provides that: "On request of a party in interest, the court may order the appointment of additional committees . . . of equity security holders if necessary to assure [their] adequate representation."[152] Furthermore, it states that a "committee of equity security holders appointed under subsection (a)(2) of this section shall ordinarily consist of the persons, willing to serve, that hold the seven largest amounts of equity securities of the debtor of the kinds represented on such committee."[153]

Under Chapter 11, these committees are given the duty and power to represent the equity security holders and may:

150. In some states board committees can consist of persons who are not board members and who can be delegated authority from the board to act on behalf of the corporation. *See* MINN. STAT. § 302A.241, subdiv. 2 (2018). That is, the SAC could have real power and be more than simply advisory.

151. 11 U.S.C. §§ 1101–74 (2012).

152. *Id.* § 1102(a)(2).

153. *Id.* § 1102(b)(2).

> (1) consult with the trustee or debtor in possession concerning the administration of the case;
>
> (2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor . . . ;
>
> (3) participate in the formulation of [reorganization] plan[s] . . . ;
>
> (4) request the appointment of a trustee or examiner . . . ; and
>
> (5) perform such other services as are in the interest of the equity security holders."[154] The bankruptcy committee also has the power "with the court's approval . . . [to] select and authorize the employment . . . [of] attorneys, accountants, or other agents to represent or perform services for such committee."[155]

The nature and extent of the role of these shareholder bankruptcy committees can provide a guide for how SACs might be employed outside of the bankruptcy context.

There are also mandatory and voluntary models from other countries. In Sweden, shareholders are given the role of the nominating/corporate governance committee of a U. S. company.[156] The Swedish Nominating Committee is mandatory and consists of at least three members, appointed by the shareholders, all of which must be shareholders themselves and a majority of which must be independent of the company and its executive management.[157] Neither the chief executive officer nor other members of the executive management can be members of the nominating committee.[158] The Swedish Nominating Committee proposes candidates for the board and board compensation whose proposals are acted upon at the shareholders' meeting.[159]

As a voluntary model, a French company, Groupe PSA (Groupe),[160] has a SAC that acts as a consultative body to relay the expectations of the shareholders and to help develop shareholder communication resources.[161] The committee consists of

154. *Id.* § 1103(c).

155. *Id.* § 1103(a).

156. Svensk kod fÖr bolagsstyrning [Corporate Governance Code] 3: 2 (Swed.).

157. *Id.* at 3:2.1.

158. *Id.*

159. *Id.*

160. Groupe PSA is a French multinational manufacturer of automobiles and motorcycles sold under the Peugeot, Citroën, DS, Opel, and Vauxhall brands. *See* GROUPE PSA, https://www.groupe-psa.com/en/automotive-group/history (last visited Jan. 30, 2019).

161. *See Shareholders' Advisory Committee*, GROUPE PSA, https://www.groupe-psa.com/en/finance/individual-shareholders/advisory-committee (last visited Jan. 30, 2019). Some other French companies have shareholder advisory committees. For example, AXA, a global insurance company, has a shareholder advisory committee, which was created "to establish a regular and meaningful

twelve shareholder members elected for three-year terms, with one-third of the members up for election each year.[162] Committee membership is intended to reflect the Groupe's diversified ownership interest and be a balanced representation of its retail shareholder base.[163]

The Bankruptcy Code shareholder committee, Swedish Nominating Committee, and Groupe SAC are at least three ways that SACs could be implemented. As an initial matter, publicly held companies in the United States may be wise to explore the use of SACs on a voluntary basis, both from an engagement perspective and to be proactive in order to avoid a possible regulatory mandate for their creation. Although historically, such forward-looking action might be unlikely for most public companies,[164] this would be a great way to work with some of the company's largest shareholders and to garner their trust and support in advance of any activist shareholder attack.

Beyond voluntary creation, the push for engagement between shareholders, the board, and management through the creation of SACs could be accomplished in the manner of some of the previously discussed shareholder democracy victories, that is, through the shareholder proposal process. Institutional investors could create a template resolution to be presented to corporate boards on SACs in the same manner that majority voting and proxy access resolutions were championed in the past.[165] The resolutions would get managements' attention and, at some point, those resolutions may garner majority shareholder votes, which would be difficult for management to ignore.

Finally, shareholder advisory groups could be implemented by regulatory mandate. Indeed, there is history to build upon.

dialogue between the company and its individual shareholders." *See Advisory Committee for Individual Shareholders*, AXA, https://group.axa.com/en/about-us/commitee/advisory-committee-individual-shareholders (last visited Jan. 30, 2019). The committee has twelve members, attempts to reflect the occupational and geographical diversity of the body of AXA shareholders, and meets twice a year to examine various issues. *Id.*

162. *Shareholders' Advisory Committee*, *supra* note 161.

163. *Id.*

164. Barrall, *supra* note 141 ("Historically, despite some management engagement with shareholders, companies have seen little in the way of direct dialogue between shareholders and members of the board of directors. For most public companies, governance strategies have seldom included systematic engagement with shareholders beyond quarterly earnings calls, investor conferences and traditional investor relations efforts.").

165. *See supra* Part II.A.2–A.5.

Prior to 2002, there was no substantial federal regulation of corporate boards of directors or of their committees.[166] In 2002, the Sarbanes-Oxley Act instituted sweeping governance changes and called for the SEC to implement rules and procedures on various topics.[167] The SEC prodded the national stock exchanges to make changes to the governance structure of public corporations and the stock exchanges responded.[168] As a result, today all publicly traded companies must have three board committees, a nominating/corporate governance committee, a compensation committee, and an audit committee, all composed of independent directors.[169] The SEC could once again mandate that the stock exchanges take action, requiring companies to implement SACs. After all, one of the fundamental purposes of federal regulation of the securities markets is to enhance the flow of information between companies and shareholders.[170] The required creation of SACs would help ensure that reliable information flows between the company and its shareholder base by putting a group of shareholders in direct contact with the board and management.[171]

Shareholders will undoubtedly be interested in providing input on board size, composition, compensation, and diversity by way of an SAC. Other topics of shareholder interest may be executive compensation (say on pay), changes in the corporate governance documents, mergers or other fundamental changes, business strategy and development, and environmental and social issues. Whether proposed by shareholders as a resolution for board adoption under the proxy rules or mandated by the SEC

166. With adoption of the Sarbanes-Oxley Act of 2002 and related Securities and Exchange Commission regulations, the federal government has taken a more direct role in corporate governance regulation. Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 962 (2003).

167. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15, 18, 28, and 29 U.S.C.).

168. *See* NASD and NYSE Rulemaking: Relating to Corporate Governance, Exchange Act Release No. 34-48745, 68 Fed. Reg. 64,154 (Nov. 12, 2003).

169. *Id.* at 64,157–58.

170. *See* Aguilar, *supra* note 51 ("As you well know, disclosure is the foundation of our federal securities laws. Fair and accurate disclosure has been the central goal of U.S. securities laws for 80 years.").

171. *See also id.* ("In doing all this, institutional investors—like all investors—depend on the assurance of a level playing field, access to complete and reliable information, and the ability to exercise their rights as shareowners. That is why fair and intelligent regulation is necessary for the proper functioning of our capital markets.").

through the stock exchanges, a sample formulation for the creation, constitution, and function of an SAC might look as follows:

> The Company shall have a Shareholder Advisory Committee to advise the Board of Directors and the management on the interests of shareholders. The Committee shall be composed of at least nine members selected on an annual basis. The Board shall establish appropriate procedures for selection of members, provided that 1) each member must have continuously held at least $2,000 in market value, or 1%, of the company's securities for at least one year;[172] 2) no member has any affiliation with the Company other than as a shareholder; 3) at least three members are selected from the 20 largest owners of the Company's voting shares; and 4) the Committee has diverse representation among types and classes of shareholders. Members of the Committee shall serve without compensation, except that the Committee shall be reimbursed for normal travel and operating expenses.
>
> The Committee shall advise the Board on 1) the size of the Board and potential nominees to the Board of Directors, including enhancing and maintaining Board diversity; 2) creation of and appointment to Board committees; 3) compensation of the Board and management; 4) fundamental corporate changes, such as proposed amendments to the Company's certificate and bylaws, 5) mergers, acquisitions, recapitalizations, and similar transactions; 6) business strategy and development; 7) environmental, social and governance matters; and 8) other matters on which the Board seeks the Committee's input and advice. The Board of Directors shall ensure the formation and effective operation of this Committee, with adequate resources to carry out the Committee's functions, including allowing Committee retention of experts or advisors to the Committee, as necessary. The Board shall give due consideration to such advice and proposals as shall be reported by this Committee to the Board. The Company's proxy statement and annual report shall report on the activities of the Committee.
>
> The Committee shall be open to communication with, input from and actively engage with other shareholders who are not currently on the Committee, and report to the Board and other shareholders on such communication and the Committee's responsiveness.

This proposal is intentionally skeletal. The specifics of the SAC may vary from company to company, crafted ideally after consultation with representatives from the company's shareholder base. For example, the terms for SAC members may be one year or longer. If longer, the terms might be staggered so as to provide for continuity on the committee.[173] Representatives on the SAC may be self-nominated. If there are more shareholder representatives seeking to participate than spots on the SAC,

172. This language and these ownership requirements are identical to those under the SEC's shareholder proposal rule for shareholders who want the company to include a proposal in the company's proxy statement. *See* Shareholder Proposals, 17 C.F.R. § 240.14a-8(b) (2018). It is intended to ensure that the shareholder has some substantial and longer-term interest in the company.

173. *See supra* text accompanying notes 61–67.

the company's board can either expand the SAC or provide a means for selecting among the nominees. Similarly, positions on the SAC may be reserved for long-term or large shareholders, or representatives of other shareholder types.

SACs have the potential to solve one corporate communication and governance problem, that is, ensuring that shareholders as a group have a representative and continuing voice in dealing with management and the board. This solution only enhances shareholder democracy to a certain point. If individual shareholders are given special access to the corporate governance process, SACs' effectiveness can be muted, if not negated. The next Part discusses the uneven access that corporate boards and management grant to activist investors through special interest governance agreements, a process that counteracts SACs' enhancing effect on shareholder democracy.

III. THE PROBLEMS WITH SPECIAL INTEREST GOVERNANCE AGREEMENTS

> "Activists are in fact the public company's unlikely saviours. . . . [A]ctivists are a force for good."[174]

> "In short, activist hedge funds are vultures, not saviors. They seek to feed off the healthy as well as the sick, and encourage vulture-like behavior in others, corrupting those who should know better, like schoolteachers' pension funds."[175]

Activist investors come in many shapes and sizes. They may be hedge funds, institutional investors, or individuals.[176] Similarly, investor activism can take many forms, and can have many objectives. The key common denominator among the different shapes, sizes, forms, and objectives is change.[177] That change

174. *Capitalism's Unlikely Heroes: Why Activist Investors Are Good for the Public Company*, ECONOMIST (Feb. 5, 2015), https://www.economist.com/news/leaders/2015/02/05/capitalisms-unlikely-heroes.

175. Steve Denning, *The Seven Deadly Sins of Activist Hedge Funds,* FORBES (Feb. 15, 2015), https://www.forbes.com/sites/stevedenning/2015/02/15/the-seven-deadly-sins-of-activist-hedge-funds.

176. *See* Loop et al., *supra* note 3 (describing the attributes and proclivities of the three main types of activist investors: hedge funds, institutional investors, and individuals).

177. *Id.* ("Activism is about driving change. Shareholders turn to it when they think management isn't maximizing a company's potential. Activism can include anything from a full-blown proxy contest that seeks to replace the entire board, to shareholder proposals asking for policy changes or disclosure on some issue. In other cases, shareholders want to meet with a company's executives or

may include seeking a sale or breakup of the company, challenging the board and management's operational path, replacing the CEO, demanding a special dividend to shareholders, discussing financial control or reporting issues, and addressing a lack of responsiveness on environmental or social concerns.[178]

One of the issues surrounding shareholder activism, widely discussed and written about, is so-called short-termism.[179] Scholars and commentators argue that activist shareholders with only short-term interests may seek, and bring about, substantial changes that harm the prospects of some of the corporation's long-term goals.[180] Hedge funds and other activists frequently pressure boards and management to take actions, such as stock buybacks, special dividends, spin-offs, and other corporate reorganizations that will boost immediate stock prices.[181] Resources that are used for these short-term activities are then unavailable for projects with a longer time frame or potential return, such as product research and development.[182] What's worse, shareholder activists are not restrained by fiduciary duties to the company[183] and therefore are free to act as they wish.[184]

directors to discuss their concerns and urge action. The form activism takes often depends on the type of investor and what they want.").

178. *Id.*

179. *See* Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. L. 1 (2010). *But see* Bebchuk & Kahan, *supra* note 10 (arguing that the shareholders' ability to intervene results in the long-term benefits to the company, shareholders, and economy); *see also* Lucian Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1085 (2015) (stating there is no empirical evidence supporting the argument that interventions by hedge funds impact long-term goals of the companies and shareholders detrimentally).

180. *See supra* note 179.

181. EMMERICH ET AL., *supra* note 19, at 446.

182. *See* Tomislav Ladika & Zacharias Sautner, Managerial Short-Termism and Investment: Evidence from Accelerated Option Vesting (Aug. 17, 2018) (unpublished manuscript), https://ssrn.com/abstract=2286789.

183. *See* EMMERICH ET AL., *supra* note 19, at 447.

184. Institutional investors and hedge funds do owe fiduciary duties to their owners. Another identified concern is the fact that shareholder activists may disregard the interests of those whose shares they manage. These duties may conflict with their duties if they become members of a target company's board of directors. *See* Kai Haakon E. Liekefett, *Think Twice Before Settling with an Activist,* HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 22, 2016), https://corpgov.law.harvard.edu/2016/12/22/think-twice-before-settling-with-an-activist. In order to make sure direct stockholders (i.e. mutual funds and hedge funds) act in the best interests of those whose money they manage, some suggest that activist investors should bear some costs they impose and disclose more

This Article's concern, however, is not with the activist investor's identity, his or her investment time frame, or even whether his or her actions bring value or not. Rather, the concern is with the process that has evolved whereby an activist investor acquires some small percentage of company shares, demands managerial and operational change, may threaten a proxy contest to oust the board, and then settles by entering into a private agreement with the company without the knowledge, participation, or approval of the remaining shareholders.[185] More importantly, these special interest agreements provide benefits to the activist, primarily in the form of immediate appointment to the board of directors, that are inconsistent with corporate governance and that are purchased by the board as the price of peace.[186]

Some have said that the corporate raiders of the 1980s have simply rebranded themselves and are the activist investors of today.[187] This analogy is inapt. The corporate raiders of the 1980s typically sought to acquire the company at a premium

information about their incentives. Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 476, 488–91 (2014); *accord* Usha Rogrigues, *Corporate Governance in an Age of Separation of Ownership from Ownership*, 95 MINN. L. Rev. 1822, 1848–55 (2010) (recognizing that the current shareholder empowerment reform is an imperfect way to address systemic risk and, under these circumstances, arguing the best empowerment reform strategy should consider aligning the interests of individual investors with the interests of their intermediaries through which they invest).

185. Activist interventions resulting in settlements need not always be related to proxy fights. Between 2000 and 2011, there were over 2000 activist interventions in publicly held companies, whether or not directly involving a proxy fight, with the percentage of settlements increasing each year. *See* Bebchuk et al., *supra* note 7, at 8–9.

186. As for motivations of the actors involved in such settlement agreements, some scholars have suggested that boards are motivated to avoid the costs, distractions and negative publicity associated with proxy contests. Derek D. Bork, *Settlement Agreements with Activist Investors–the Latest Entrenchment Device,* HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 7, 2016), https://corpgov.law.harvard.edu/2016/07/07/settlement-agreements-with-activist-investors-the-latest-entrenchment-device. Some have argued that the boards have started to recognize the value that activists and other shareholder representatives can bring to a board. *Id.* Others have reasoned that the drivers behind settlements may be not so noble, but rather settlements have become a defensive measure and entrenchment device to handcuff the activists while allowing the board to maintain control. *Id.*

187. Aaran Fronda, *The Rebranding of Corporate Raiders*, WORLD FIN. (Mar. 9, 2016), https://www.worldfinance.com/strategy/the-rebranding-of-corporate-raiders.

price out of which all shareholders received a pro rata cut. Today's activist investor does not seek to acquire the company. Rather, the activist investor typically threatens a proxy fight to unseat the board.[188] If the battle proceeds to a vote, all shareholders can vote as to whom they want running their corporation. On the other hand, if the activist investor settles its challenge prior to a vote with a private agreement between it and the board, other shareholders do not have any say in the result. Thus, these agreements eliminate the shareholder voices that SACs, and shareholder democracy in general, sought to enhance. This is the danger of special interest governance agreements.

Long-term institutional investors have raised issues with this process. In the aggregate, shareholder activists hold a very small percentage of public company stock, which is not enough to play a determinative role in vote outcomes.[189] To succeed in proxy contests and other campaigns, activists depend on the support of the large institutional investors that dominate the share ownership space.[190] However, activists do not need this support if the company enters into a private interest agreement. Moreover, settlements with individual activists have been happening so quickly that a number of institutional investors have expressed their concerns that companies are both entering into settlements without giving sufficient time for other shareholders to provide their views,[191] and compromising long-term interests for short-term priorities.[192] In fact, long-term institutional investors may prefer that the companies engage in a proxy fight in order to give long-term investors a chance to express their views and have their vote be counted.[193]

How prevalent is this practice of activist investor special interest governance agreements?

188. *See* Lipton, *supra* note 5.

189. Glen T. Schleyer et al., *Sullivan & Cromwell Reviews and Analyzes 2016 U.S. Shareholder Activism*, CLS BLUE SKY BLOG, at 3 (Dec. 15, 2016), http://clsbluesky.law.columbia.edu/2016/12/15/sullivan-cromwell-reviews-and-analyzes-2016-u-s-shareholder-activism/.

190. *Id.*

191. *Id.* at 12.

192. Protecting Long-Term Shareholder Interests in Activist Engagements, Market Commentary, State Street Global Advisors (Oct. 10, 2016), https://corpgov.law.harvard.edu/2016/10/17/protecting-the-interests-of-long-term-shareholders-in-activist-engagements/ [hereinafter State Street Global Advisors].

193. Liekefett, *supra* note 184.

Consider this comparison: In 2001, more than sixty percent of threatened proxy contests went to a vote and only twenty percent resulted in special agreement settlements;[194] in 2018, only twenty-two percent were carried to a vote and seventy-eight percent settled with special agreements.[195] It has been noted that "[w]hile such settlements used to be rare, they now occur with significant frequency."[196] Moreover, they are happening fast: "The time period between the beginning of an activist campaign and a settlement has contracted significantly—from 146 days in 2013 to 60 days in 2016. Corporate America is capitulating."[197] The next two Sections identify the benefits of these special deals to the activist and to the board, respectively.

A. ACTIVIST BENEFITS—BOARD REPRESENTATION PLUS

The crucial benefit activists gain in special interest settlement agreements is immediate representation on boards of directors of target companies.[198] The desire to infiltrate the board is not surprising. The goals typically identified by activists, such as operational changes, special dividends or stock buybacks, possible merger or sale, and replacing the CEO, are actions either

194. *Id.* The remaining ones either were abandoned or otherwise mooted. At least as important is the fact that "many companies are still choosing to grant board seats to activists before the campaign evolves into a proxy fight situation." Andrew Birstingl, *2016 Shareholder Activism Trends,* FACTSET (Dec. 12, 2016), https://insight.factset.com/2016-shareholder-activism-trends.

195. LAZARD LTD., LAZARD'S ANNUAL REVIEW OF SHAREHOLDER ACTIVISM – 2018 (2018), https://www.lazard.com/media/450805/lazards-2018-review-of-shareholder-activism.pdf. In 2017 the numbers were even starker, with eighty-six percent threatened activist contests leading to negotiated settlements. Jim Rossman, *Review of Shareholder Activism: 1H 2018*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 30, 2018), https://corpgov.law.harvard.edu/2018/07/30/review-of-shareholder-activism-1h-2018; *see also* Liekefett, *supra* note 184. "The vast majority of activist situations result in a negotiated settlement between the activist and the target company." *Id.*

196. Bebchuk et al., *supra* note 7, at 2. These statistics relating specifically to proxy fights portray only a small portion of the actual activist interventions and resulting settlement agreements. Many activist interventions do not actually involve a proxy contest. *Id.* at 5–9.

197. Liekefett, *supra* note 184.

198. Rossman, *supra* note 195. In 2018 activists won 161 board seats, the largest number in history, up fifty-six percent from 2017 and eleven percent higher than the previous record of 145 seats in 2016. LAZARD LTD., *supra* note 195, at 1.

fully delegated to the board or at least requires board initiation.[199] Board representation is thus a rational and essential means to accomplish these ends.[200]

The problem here is the process by which activists acquire these board seats. They receive their seats without owning enough shares to elect their candidates, and without campaigning for and obtaining a passing shareholder vote approving their nominees. The achievements of shareholder democracy, including proxy access and majority shareholder voting for director election, are ignored—activists achieve the same result without following the rules that have been created for all.[201]

Consider this situation. In March of 2016, activist hedge fund Starboard Value LP, which owned only 1.7% of Yahoo! Inc., threatened a proxy fight to replace the entire nine-member board of Yahoo, including Chief Executive Officer Marissa Mayer.[202] Starboard stated that it was "extremely disappointed with Yahoo's dismal financial performance, poor management execution, egregious compensation and hiring practices, and general lack of accountability and oversight by the Board."[203] After only thirty-two days, and without any input or vote from other shareholders, Yahoo and Starboard settled. Starboard was granted four board seats and the Yahoo board immediately expanded its size to thirteen members to accommodate these new members.[204] Yahoo additionally promised to nominate those four

199. Bebchuk et al., *supra* note 7, at 5–6.

200. *Id.* at 15–17.

201. "Since 2015, activists have secured 198 board seats at companies with market values above $500 million, according to data from Lazard Ltd (LAZ.N), with most of those seats gained through settlements. That is 30 percent more than the prior two full years combined." Michael Flaherty, *Big Funds Push Back Against Activist Investor Settlements,* REUTERS (July 18, 2018), https://www.reuters.com/article/us-activist-investors/big-funds-push-back-against-activist-investor-settlements-idUSKCN0ZY2DP.

202. Yahoo Inc., Proxy Statement (Schedule 14A) (Mar. 24, 2016) [hereinafter Schedule 14A]; Michael Flaherty & Supantha Mukherjee, *Starboard Launches Proxy Fight to Remove Entire Yahoo Board*, REUTERS (Mar. 24, 2016), https://www.reuters.com/article/us-yahoo-starboard-proxy/starboard-launches-proxy-fight-to-remove-entire-yahoo-board-idUSKCN0WQ0D7.

203. *Id.*

204. Yahoo Inc., Schedule 13D (Form 13D) (June 25, 2014) [hereinafter Yahoo Form 13D]. Starboard also got representation on all board committees. Section 3.2 of the bylaws of Yahoo allow the board to set the size of the board. *See* Yahoo Inc., Amended and Restated Bylaws (Form 8-K) (Exhibit 3.2) (June 27, 2014).

Starboard directors for election at the next annual meeting and to reduce the board to eleven at that time.[205]

What is wrong with this process and result? Starboard only owned 1.7% of Yahoo's stock and it got four of its personal designees appointed to the Yahoo board without any shareholder vote or approval. Whether the Yahoo board was made up of nine, eleven, or thirteen members, Starboard's meager ownership percentage would not have permitted it to elect any directors in the normal course of conduct. Even under the most minority shareholder friendly voting process, cumulative voting—which was not in place at Yahoo[206]—Starboard would not have had the ability to elect even one director. Rather, Starboard would have had to own more than four times the number of shares it actually owned to elect one Yahoo board member and would have had to own nearly thirty percent of Yahoo's stock in order to elect four members to a thirteen-member board.[207] Moreover, the Yahoo board unilaterally agreed to expand the size of the Yahoo board immediately in order to make room for the Starboard representatives. This is special interest governance.

The true irony of this situation is that Yahoo previously had amended its bylaws to adopt a majority vote standard for the election of directors in response to the move for majority voting in director elections,[208] as discussed above.[209] No shareholder vote, however, was ever taken at Yahoo for Starboard to get four board seats.[210] The process that the Yahoo shareholders had ad-

205. *Id.*

206. Schedule 14A, *supra* note 202, at 14 ("Shareholders are not entitled to cumulate votes in the election of directors."). Cumulative voting allows a minority shareholder to get representation on the board of directors depending on the percentage of shares owned and the number of directors up for election.

207. Cumulative voting allows shareholders to cumulate their votes in the election of directors. The formula for determining the percentage necessary to elect one director is to divide 100 by the number of directors to be elected plus one. Here that would be 100 divided by 13 or 7.14%. To elect four directors a shareholder would need four times that amount, or 28.57%.

208. Schedule 14A, *supra* note 202 ("Our Bylaws provide that, in an uncontested election, each director nominee must receive a majority of votes cast in order to be elected to the Board. A 'majority of votes cast' means the number of shares voted 'FOR' a director nominee exceeds the number of shares voted 'AGAINST' that director nominee.").

209. *See* text accompanying *supra* notes 68–85.

210. It is a complete fallacy to argue that this process is validated because "[d]irectors who enter the board through settlements do not receive less voting support at the following annual general meeting than incumbent directors or those activist directors who get on the board without a settlement." Bebchuk et

vocated for, and accomplished, was undone instantly by Starboard and the Yahoo board. They sidestepped the normal governance channels and made a mockery of the majority vote requirement.

One further example is Hertz. On August 12, 2014, Carl Icahn, the owner of 8.48% of the Hertz Global Holdings, Inc. stock, reported that he "intend[ed] to have discussions with representatives of the Issuer's management and board of directors relating to shareholder value, accounting issues, operational failures, underperformance relative to its peers and the Reporting Persons' lack of confidence in management. The Reporting Persons may also seek shareholder board representation if appropriate."[211] Once again, this last statement portends a potential proxy fight. Thirty-five days later, Hertz and Icahn settled, without any shareholder vote, with Icahn immediately receiving three board seats on the nine-member Hertz board.[212]

Absent the settlement with Hertz, Hertz's governing document would have required Icahn's board nominees to be elected by a "[m]ajority of shares cast."[213] Even under a cumulative voting regime, which Hertz did not have, Icahn would have needed more than ten percent stock ownership to elect even one director to the Hertz board, which he did not have. To elect three directors, he would have needed more than thirty percent. To make matters worse, the Hertz board had one of the few remaining classified boards. When the Hertz board settled with Icahn to avoid a proxy fight, they appointed his nominees to classes of directors that would not be up for shareholder election at the 2015 annual meeting.[214] Two of the Icahn directors would not be up for shareholder election until 2016 and one would not be up for election until 2017.[215] Now that's a sweet deal for Carl Icahn and a sad day for shareholder democracy and corporate governance at Hertz.

al., *supra* note 7, at 5. Investors who do not agree with the special deal and way the company is being run may well take the Wall Street Walk and sell their shares before the next meeting. In any event, once the activist appointees are on the board and are recommended by the board for approval as part of the standard slate, election is all but guaranteed. *See* text accompanying *supra* notes 105–07.

211. Hertz Global Holdings, Inc., Schedule 13D (Form 13D) (Aug. 12, 2014).

212. Hertz Global Holdings, Inc., Form 8-K (Sept. 16, 2014).

213. Hertz Global Holdings, Inc., Def 14A, at 2 (Sept. 16, 2014).

214. *Id.* at 12.

215. *Id.*

These are not isolated examples. Activist investors typically demand board representation as an essential part of the settlement package, with 87.4% of settlements resulting in the appointment of new directors either affiliated with the activist or approved by them.[216] The trend continued in 2017, with settlements granting an average of 1.7 board seats to activists.[217] Moreover, while board seats are the main prize, there are other gifts that activists receive as part of these special interest settlements. Seventy-five percent of these settlements provide that the activist board members be appointed to all, or at least the most important, board committees.[218] Moreover, companies often agree to reimburse the activist, out of company funds, for the expenses incurred in negotiating and executing the settlement agreement.[219] As will be seen in the next Section, while the benefits to activists are substantial, the deal is not completely one-sided.

B. Board Benefits—Peace at a High Price for Other Shareholders

The special interest deals are not as one-sided as one might think. Boards have secured some significant self-serving benefits as well.[220] The key to the settlement from the board's side is to halt the challenge to incumbent management, and to secure the activist's commitment not to push for further change. These are referred to as standstill provisions.[221]

For example, in late 2017, Sea World settled with an activist, Hill Path Capital, with a standstill containing the following terms, among others: Hill Path could not (1) vote its shares, or communicate with anyone else to have them vote their shares, except for board candidates recommended by the board or for actions recommended by the board of management; (2) acquire more Sea World shares; (3) sell its shares to anyone who would own five percent or more of Sea World stock; (4) make any proposal at any regular or special meeting of shareholders; (5) propose or help anyone else to propose any merger, tender offer, or

216. Bebchuk et al., *supra* note 7, at 16.

217. J.P. Morgan, The 2017 Proxy Season at 12 (2017), https://www.jpmorgan.com/jpmpdf/1320739681811.pdf.

218. Gibson Dunn, 2017 Year-End Activism Update 16–20 (2018), https://www.gibsondunn.com/wp-content/uploads/2018/01/2017-Year-End-Activism-Update.pdf; *see also* Yahoo Form 13D, *supra* note 204.

219. Gibson Dunn, *supra* note 218, at 18.

220. Schleyer, *supra* note 189, at 13.

221. *See* Bebchuk et al., *supra* note 7, at 6.

similar transaction to other shareholders, (6) make any request for Sea World's books or records; (7) seek, or assist anyone else to seek, changing the board or management of the company: (8) institute any litigation against Sea World, its board, or its management; and (9) make, or assist or encourage anyone else to make, any public statement inconsistent with support of the board or management.[222]

These provisions handcuff and gag Hill Capital. It cannot acquire more shares, even by means of a premium price purchase offer to all other shareholders. The provisions clearly insulated the Sea World board from further attack by Hill Capital, but it is not clear how they benefitted the company itself or the other shareholders. Indeed, the board appears to have sold board seats to the activist at a price that unduly entrenches the board and incumbent management. These activist concessions do not serve the interests of the company (or the other shareholders) other than to take the spotlight off the board.

Even if a board could reasonably expect to have an activist call off its proxy contest in return for board seats and other benefits without standstill provisions, boards often get a longer commitment from the activist in the provisions. The typical standstill provision spans 1.4 annual meeting cycles.[223] This means that the activist may be prohibited from taking any of the identified actions not only for the year it has been guaranteed board representation, but also for the next election cycle as well. Although this too does not necessarily benefit the general shareholder base, it does provide the board extended protection from the activist's further challenge.

This is not to say that all agreements between companies and activists are inherently bad. Rather, the point is that, by unilaterally entering into such shareholder settlement agreements, boards undermine the past achievements of shareholder democracy to the detriment of shareholders who are left out of the process. The most significant institutional shareholders have voiced their "wariness about rapid settlements with activists without the input of long-term shareholders."[224] These concerns

222. SeaWorld Entertainment, Inc., Form 8-K (Nov. 7, 2017). These are typical standstill provisions. *See* Bork, *supra* note 186.

223. J.P. MORGAN, *supra* note 217, at 12.

224. CAMBERVIEW PARTNERS, Responding to Investor Concerns Regarding Activist Settlements, http://camberview.com/images/news/131209335526997862.pdf. As stated by the head of the largest global institutional shareholder, BlackRock:

> Where activists do offer valuable ideas — which is more often than

are real and deserve a resolution. The next Part turns to one potential resolution.

IV. SOLVING THE SPECIAL INTEREST SETTLEMENT GOVERNANCE PROBLEM

> The challenge for corporate law is to facilitate the development of a corporate structure that allows management the discretion to utilize its expertise on behalf of shareholders, but at the same time establishes safeguards in situations in which management might utilize that discretion to favor itself at the expense of shareholders.[225]

In entering into special interest settlement agreements, boards and management are operating in a conflict of interest context. They are obligated to represent the best interests of the company and the shareholders as a whole. Yet an activist poses a clear, vocal, and direct challenge to the board's and management's credibility as business persons, to their business plan for the company, and to their fundamental ability to continue in their current positions. It is a personal and professional attack. For outside board members, this means a potential loss of prestige and significant income, ranging from $200,000 to $300,000 per year,[226] with the top twenty highest paid boards' directors receiving from $346,000 to over $2,000,000 per year.[227] Of course, for the CEO and other management members, the stakes are even higher, with their jobs and even higher income at risk.[228]

The next Section posits that the resolution of this special interest governance problem requires a return to basic legal rules

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> some detractors suggest — we encourage companies to begin discussions early, to engage with shareholders like BlackRock, and to bring other critical stakeholders to the table. But when a company waits until a proxy proposal to engage or fails to express its long-term strategy in a compelling manner, we believe the opportunity for meaningful dialogue has often already been missed.

Fink, *supra* note 140, at 2.

225. 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 384 (AM. LAW INST. 1994).

226. Eric Graves & Thomas Kohns, *2016 Director Compensation Report,* HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (DEC. 12, 2016), https://corpgov.law.harvard.edu/2016/12/12/2016-director-compensation-report.

227. *The 20 Highest-Paid S&P 500 Boards of Directors,* EQUILAR BLOG (Oct. 5, 2016), http://www.equilar.com/blogs/162-highest-paid-directors.html.

228. The Economic Policy Institute found that "in 2016 CEOs in America's largest firms made an average of $15.6 million in compensation." Lawrence Mishel & Jessica Schieder, *CEO Pay Remains High Relative to the Pay of Typical Workers*, ECON. POL'Y INST. (July 20, 2017), http://www.epi.org/files/pdf/130354.pdf.

governing corporate activities and an application of those rules to the activist settlement scenario. The following Section proposes a process for harnessing special interest settlement agreements consistent with the applicable legal standards. That resolution is embodied in a model provision to be adopted by companies or imposed by regulators.

A. APPLICABLE CORPORATE LAW PRINCIPLES

There is a need to balance the board of directors' authority to manage the business and affairs of the corporation with the concern over conflict of interest in special interest governance settlements. These are situations where the board's duty of loyalty is implicated. There are several corporate law principles that may guide formulating that balance and providing a resolution.

A starting point is the hostile takeover context and the adoption of defensive measures. In this context, which has elements akin to activist threats, the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*,[229] acknowledged an inevitable board conflict of interest. It stated, "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."[230] There, the Court imposed an obligation that the board demonstrate the necessity for any defensive measure before they may adopt it.[231]

Although adopting takeover defense measures has similarities to special interest agreements with activist investors, the conflict is even more acute in the activist context. In the latter situation, without exception, the activist is directly confronting the board and management as to its capacity and performance. The activist is looking to change the board or management in order to facilitate further operational changes, a special payment to shareholders, or a sale or breakup of the company. The board's

229. 493 A.2d 946, 946 (Del. 1985). Delaware law is used here as the statutory and judicial example because it is the leading corporate law state and a majority of publicly held companies are incorporated under Delaware law.

230. *Id.* at 954.

231. "In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership." *Id.*

continued existence in its present form is at stake. The "omnipresent specter that a board may be acting primarily in its own interests" is real. The board should therefore be likewise obligated to demonstrate the necessity of a special interest agreement.

A second analog between traditional corporate law and the activist investor settlement agreement situation is the so-called interested director transaction. In this setting, the board member enters into a contract with the company in which the director has an interest in both sides of the contract's contemplated transaction.[232] In this context, the agreement is presumed to be "void or voidable."[233] One method to validate such contracts is for directors who are not implicated in the transaction to approve the contract, that is, if a "board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors."[234] Unfortunately, this approval method is not available in the context of special interest activist agreements. The board as a whole is directly interested in the outcome of the activist's threat, and so none of the board members are appropriately "disinterested."

An alternative mechanism to validate director conflict of interest transactions is independent shareholder approval.[235] As such, an interested director agreement is not void or voidable if "[t]he material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the stockholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the stockholders."[236] That is, to validate the agreement, interested directors must fully disclose the terms of the agreement and all of the company's shareholders must approve the agreement. This is a better fit for validating special interest activist investor agreements. The board is conflicted, so the shareholders should have the right to vote on the agreement. If directors decide not to pursue the validating vote, or if the vote is negative, the agreement is invalid. In this process, shareholder democracy is preserved.

232. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (2018) (Interested directors; quorum).
233. *Id.* § 144(a).
234. *Id.* § 144(a)(1).
235. *Id.* § 144(a)(2).
236. *Id.*

A further aspect of activist settlement agreements implicates traditional corporate jurisprudence. In almost all of these situations, the board and the activist settle their dispute in order to avoid an imminent proxy fight for board seats that would be decided by the shareholders as a whole in a vote at a shareholder meeting.[237] Thus the non-activist shareholders lose the opportunity to decide the matter for themselves because the board and the activist preempt that right through the special interest agreement appointing the activist's directors without a shareholder meeting or vote.

Delaware courts have been particularly diligent in protecting the shareholder franchise from usurpation by board action. Interestingly, the initial case in this area involved action by a board to accelerate the date for the annual shareholder meeting to minimize the time for dissident shareholders to wage a proxy fight.[238] The Court invalidated this attempt:

> [M]anagement has attempted to utilize the corporate machinery and the Delaware Law for the purpose of perpetuating itself in office; and, to that end, for the purpose of obstructing the legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management. These are inequitable purposes, contrary to established principles of corporate democracy.[239]

Under this holding, the shareholder voting franchise is sacrosanct and the board must respect shareholders' rights to express themselves on issues of corporate policy and governance.

In *Blasius Industries, Inc. v. Atlas Corp.*,[240] the Court once again addressed the issue of board actions that thwart shareholder democracy. The Atlas board added two directors in an attempt to frustrate shareholder Blasius' action to name a majority of the board by exercising its shareholder right to elect directors. The Court held that the business judgment rule did not apply because "[a]ction designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder majority."[241] Moreover, the Court stated that in such cases, a *per se* rule of invalidity was not appropriate either. Rather, in such circumstances, the Court held

237. Schoenfeld, *supra* note 7 ("Investors motivate management and the board to come to the bargaining table by threatening to: wage a proxy fight").

238. Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971).

239. *Id.* at 439.

240. 564 A.2d 651 (Del. Ch. 1988).

241. *Id.* at 660.

that "the board bears the heavy burden of demonstrating a compelling justification for such action."[242] In language with ringing applicability to the special interest agreements with activist investors this Article addresses, the Court stated that "[t]he duty of the courts to protect the stockholder vote is at its highest when the board action relates to the election of directors or other instances of directorial control."[243]

It appears that special interest agreements between boards and activist investors, in which the activist names directors to the board without a shareholder vote, implicates elements of both the interested director transaction analysis and the interference with shareholder democracy analysis. Boards should not be able to bind the company to a self-interested agreement protecting their own positions without shareholder validation. Moreover, directors should not be able to usurp shareholders' right to elect directors without a compelling justification. Applying the "compelling justification" standard is appropriate "in circumstances in which self-interested or faithless fiduciaries act to deprive stockholders of a full and fair opportunity to participate in the matter [to be voted on] and to thwart what appears to be the will of a majority of the stockholders."[244] Such circumstances are present in the activist shareholder settlement context. It would be wise to follow the guidance of corporate law to create a context-specific solution. The next Section presents such a solution.

B. Resolution: Mandatory Shareholder Approval or Compelling Justification

In almost all circumstances, these special interest agreements happen before an annual meeting of the shareholders, at which the shareholders would vote to elect the board.[245] This is why the activist threatens a proxy contest. If the board unilaterally avoids the effectiveness of that vote by way of a preemptive

242. *Id.* at 661. The Delaware Supreme Court has adopted the *Blasius* "compelling justification" standard. *See* Williams v. Geier, 671 A.2d 1368, 1371 (Del. 1996).

243. Esopus Creek Value LP v. Hauf, 913 A.2d 593, 602 (Del. Ch. 2006).

244. *In re* MONY Grp., Inc. S' holder Litig., 853 A.2d 661, 674 (Del. Ch. 2004).

245. "Many activist situations settle in private, confidential negotiations before any public agitation by the activist begins and long before the shareholder meeting." Liekefett, *supra* note 184.

agreement with the activist, the shareholders lose any meaningful right to decide if the activist directors should be on the board.[246]

The key to preserving and enhancing shareholder democracy in the activist investor settlement context is to give the other shareholders the opportunity to vote, no matter the subject of the vote. If the board is unable to avoid a shareholder vote, it may nonetheless determine the subject and content of the vote. If the board is allowed to enter into an agreement with the activist but must present that agreement for approval to the shareholders as a whole, the board can make a choice. The board can either refuse to accede to the activist's demands and proceed to a potential proxy fight, where the shareholders as a whole will decide which slate of directors to elect. Alternatively, the board can enter into an agreement with the activist, but must present that agreement to the shareholders as a whole for approval. Either way, the shareholders' right to determine who sits on the board of directors will be preserved.

We recognize, however, the strong tradition of deference to corporate boards with respect to how they manage and direct the operations of the corporation. It appears contrary to these general principles of board freedom to require shareholder approval for all agreements or situations in which the board may agree to appoint directors. For example, what if the board is engaging in a financing transaction with a third party investor and the investor is willing to take preferred stock so long as the investor gets a board seat? Here, there is no conflict and the board should be able to enter into that agreement without shareholder approval. Similarly, the company may engage in a joint venture with a third party, in which the third party wants to have board representation. The board should be able to make that appointment without seeking approval of the shareholders. Each of these are valid corporate transactions that may reasonably involve a board appointment without any apparent conflict of interest on the part of the board.

Therefore, the best resolution of the special interest activist investor agreement conundrum is to provide that such an agreement is invalid unless it receives shareholder approval, as in the case of shareholder approval of director conflict of interest trans-

246. It is no answer to say that the remaining shareholders may later get to vote whether to keep the activist investors on the board. *See* State Street Global Advisors, *supra* note 192.

actions generally, unless the board can demonstrate a compelling justification for entering into the agreement without seeking shareholder approval. Incidentally, but not insignificantly, creating the presumption that the agreement will be submitted to the shareholders increases shareholder engagement by requiring that the issue be disclosed, explained, and voted upon, which is what the institutional shareholders have been seeking.

Using the current Delaware interested director statute as a model, a proposed statute for the validation of activist investor agreements is set forth below, which might be new section 147 of the Delaware General Corporation Law. Alternatively, the language could be revised slightly as a shareholder resolution for an amendment to the bylaws of any corporation. Approached in this manner, any institutional shareholder or shareholders could pursue a campaign, similar to those discussed above in connection with the destaggering of boards, majority voting for directors, and proxy access, with companies adopting the provision on an individual basis. Indeed, it is hoped that these proposals to individual companies, and the proposals' adoptions, would become the newest success of shareholder democracy.

§ 147 Agreements Involving Appointment of Directors

A contract or agreement between a corporation and a stockholder[247] (or its affiliates) under circumstances in which the stockholder's (or its affiliates') recommended candidates are to be named as directors to fill vacancies on the board of directors of the corporation and the stockholder (or its affiliates) agrees not to:

pursue a proxy contest with respect to the election, removal, replacement of the board;

acquire additional shares of the corporation's stock;

vote its shares, or communicate with anyone else to have them vote their shares except for board candidates recommended by the board or for actions recommended by the board of management;

make any proposal at any regular or special meeting of shareholders;

propose or help anyone else to propose any merger, tender offer or similar transaction to other shareholders;

make any request for the corporation's books or records;

seek, or assist anyone else to seek, changing the board or management of the company;

institute any litigation against the company, its board or management; or

make, or assist or encourage anyone else to make, any public state-

247. The term "stockholder" is used in the statute instead of shareholder since that is the convention used in the Delaware corporate code.

ment inconsistent with support of the board or management,is void unless (i) the material facts as to all of the terms of the contract or agreement are disclosed or are known to the stockholders entitled to vote thereon, and the contract or agreement is specifically approved in good faith by vote of the stockholders, or (ii) the board bears the burden of demonstrating a compelling corporate justification for the contract or agreement, such as a merger, consolidation, joint venture, issuance of shares to raise capital, or other bona fide third party transaction. A compelling corporate justification does not result simply from the avoidance of a potential proxy fight, conservation of corporate or management resources, avoidance of negative publicity for the corporation, maintenance of the ability to pursue the corporation's business plan without challenge or interference, or similar purported benefits.

Reporter's Notes

This provision is designed to restrict the situations in which an activist acquires a stake in a company and then advocates for change. The activist and the board then agree to settle the matter with the activist executing a standstill agreement in return for board seats. These settlements usurp the authority of the shareholders in the election of directors because the board acts unilaterally to appoint the activist's candidates to current or created vacancies on the board. These appointments are not made in connection with bona fide substantive transactions involving the corporation but rather primarily to curtail the activist investor's threats to the board and incumbent management. This provision requires that these activist investor settlements are invalid unless they receive approval of the stockholders of the corporation in a stockholder vote. In operation, then, the proposed statute would require shareholder approval for all activist investor settlements. In normal circumstances, that vote will occur at the next annual stockholder meeting.

The only exception to the requirement of a stockholder vote would be if the board can present a compelling corporate justification for the advance appointments to the board. The last sentence of the section is designed to eliminate the purported justifications often given by boards for settling with an activist investor. These and similar justifications are not compelling under the statute. Typically, only a bona fide transaction with a third party, such as a sale of preferred shares or joint venture, where board representation may be a typical attribute of that type of transaction, will support a showing of a compelling corporate justification for the board granting board seats in connection with entering into a contract or other agreement. Finally, this provision does not prevent the board from appointing individuals to fill vacancies on the board in the normal course of affairs, such as when a director retires or dies, or where the board might expand its size and appoint directors designed to improve board diversity. These appointments are not accompanied by any contract or agreement with the director, and certainly not one that prevents the director from engaging in the activities specified in parts (a) through (i), which are provisions are standard in activist investor settlement agreements.

CONCLUSION

Shareholder democracy's development over the past quarter century has been amazing. Fueled by the growth of institutional investors, the SEC's shareholder proposal process, and shareholders' desire to bring positive social change, significant corporate governance changes have been made, from majority voting for directors to a growing emphasis on environmental, social and governance issues. The time is ripe to find a way to make to institutionalize engagement between shareholders, boards, and management. The best way to do this is to have companies create shareholder advisory committees as a fundamental and ongoing mechanism to encourage effective engagement. These committees would act as a communication conduit between a company's general shareholder base and its board and management.

At the same time, activist investors are posing an ongoing threat to corporate governance and the shareholder democracy movement. Their tactics have resulted in special interest agreements with the boards of target companies. These agreements give the activist access to the inner sanctum of the board in exchange for the activist's ceasing activities that challenge the board and incumbent management. The special interest agreements circumvent the traditional corporate governance process by preventing other shareholders from participating in the selection of directors, in turn, silencing the shareholder voices that shareholder democracy generally, and SACs specifically, seek to augment. To remedy this problem, activist settlement agreements must be presented to the shareholders as a whole for approval unless the board can show a compelling justification for the agreement to be without this approval. Challenging problems call for creative solutions. The resolution proposed here meets that challenge while preserving and advancing shareholder democracy.