

THE STOCKHOLDER FRANCHISE IS NOT A MYTH: A RESPONSE TO PROFESSOR BEBCHUK

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INTRODUCTION

I am honored that Professor Lucian Bebchuk invited me to respond to his essay entitled “The Myth of the Shareholder Franchise.”¹ In his characteristically scholarly manner, he provides some cogent arguments that the stockholder franchise should be robust and needs to be invigorated to fulfill the promise of Delaware corporate jurisprudence, exemplified by former Chancellor Allen’s famous 1988 statement in *Blasius Industries, Inc. v. Atlas Corp.* that “[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”²

Stockholder power in the mid-1980s to “throw the rascals out” was theoretically strong, but it may have been more theoretical than real. I do not agree, however, with Bebchuk’s assertion that today, two decades later, “the shareholder franchise does not provide the solid foundation for the legitimacy of directorial power that it is supposed to supply.”³ Rather, in my opinion, the stockholder power to hold boards accountable and to effect meaningful change has strengthened incrementally since the mid-1980s and into the twenty-first century. This has happened over time through an appropriate blend of increased director responsibility, investor influence, modest law reform, and new mores. What is not needed

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¹ Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675 (2007).

² 564 A.2d 651, 659 (Del. Ch. 1988); see also *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.”).

³ Bebchuk, *supra* note 1, at 676.

at this juncture is a lurching change in the name of “reform” that might upset the existing balance of law and culture. This Response will examine Bebchuk’s premises and proposals to evaluate whether the premises are sound and whether the reforms he advocates would represent a net advance in corporate law or an unnecessary and potentially mischievous distraction from the goal of good governance that enhances stockholder value.

I. SUMMARY OF THE BEBCHUK PREMISES AND PROPOSALS

In substance, Bebchuk labels the stockholder franchise—the power to elect and replace board members—a “myth.” He argues that “shareholders do not in fact have at their disposal those ‘powers of corporate democracy.’”⁴ A “myth” is generally understood to be “[a] fiction or half-truth, esp[ecially] one that forms part of the ideology of a society.”⁵ Strong words. Is this really the case as applied to the stockholder franchise?

His real contention is that it is expensive and difficult for stockholders to exercise their power to replace wholesale a board of directors. His empirical support of this thesis is that “the incidence of replacement by a rival slate seeking to manage the company better as a stand-alone entity is negligible.”⁶ To be sure, wholesale removal of an entire board is rare and more difficult to achieve than selective removal or not reelecting one or more directors. But are wholesale changes in the legal regime the necessary or desirable response? I think not.

First, based on his tallies, one-third of challenges are successful.⁷ This seems fairly substantial and demonstrates to a significant extent the stockholders’ ability to exert their will under the current system. Therefore, the progression of his argument from an empirical study showing few successful attempts to replace a board to the conclusion that stockholders are impotent is a non sequitur.

⁴ Id. (quoting *Unocal Corp.*, 493 A.2d at 959).

⁵ Webster’s II New College Dictionary 742 (3d ed. 2005).

⁶ Bebchuk, *supra* note 1, at 677. I assume (without deciding) that his empirical studies are valid. In effect, I demur.

⁷ Id. at 687.

2007] *The Stockholder Franchise Is Not a Myth* 813

Bebchuk would reconfigure certain corporation law defaults in a way that he argues would provide “a viable shareholder power to replace directors.”⁸ Under his proposed default arrangements:

[A]t least every two years, elections should be held with shareholder access to the corporate ballot, reimbursement of expenses to challengers receiving a sufficiently significant number of votes (for example, one-third of the votes cast), and shareholder power to replace all directors. Furthermore, confidential voting and majority voting should be required in all elections.⁹

II. BEBCHUK’S PROPOSALS GO TOO FAR AND COULD LEAD TO UNINTENDED CONSEQUENCES

In response to Bebchuk, I will concentrate simply on two themes: (1) overarching issues of corporate law and governance; and (2) the positive developments that have occurred in recent years, which give meaning to the promise of Delaware law that stockholders have the clout they deserve. In addition to practical governance reforms that have already transformed boards and made them more responsible and responsive to stockholders, we should concentrate on the majority voting movement and the newly realized power of stockholders to use precatory and binding bylaw proposals to good effect.¹⁰

Those of us who have practiced corporate law, written judicial opinions, or counseled boards of directors on corporate governance realize that stockholders do have real power, albeit in varying degrees depending upon the corporation in question. Examples of stockholders’ opportunities to exert their power abound. First, stockholders elect directors, have statutory authority to remove directors with or without cause, and must approve mergers, charter

⁸ Id. at 679.

⁹ Id. at 677.

¹⁰ I give comparatively short shrift to the proposals for biannual election, reimbursement of campaign expenses, and the secret ballot not because those proposals are not interesting but because I cannot cover everything in the space allocated to this Response.

amendments, and the like.¹¹ Second, stockholders have potentially powerful authority to effect changes in bylaws, including implementation of majority voting. Third, stockholder voting may soon be further facilitated through the SEC's proposed internet proxy rule¹² and the NYSE's broker nonvote proposal.¹³ Fourth, stockholders may bring class actions and derivative suits, and concern about the potential for such suits is a factor that influences director behavior. Finally, stockholders' interests are protected by most directors' conscientious and professional efforts to implement best practices and to do the right thing in good-faith exercise of their fiduciary duties of loyalty and due care.

Moreover, many boards are moving voluntarily and proactively to revise their policies on many governance issues including poison pills, staggered boards, and majority voting.¹⁴ At the same time, directors must not be risk averse in carrying out their proactive statutory mandate to direct the management of the business and affairs of the corporation.¹⁵ Strong medicine of the type Bebchuk pre-

¹¹ See, e.g., Del. Code Ann. tit. 8, § 216 (2001) (election of directors); id. § 141(k) (removal of directors by stockholders); id. § 251 (Supp. 2004) (approval of merger or consolidation); id. § 242 (2001) (approval of charter amendments).

¹² Internet Availability of Proxy Materials, Exchange Act Release No. 52,926, Investment Company Act Release No. 27,182, 70 Fed. Reg. 74,598 (proposed Dec. 15, 2005) (to be codified at 17 C.F.R. pts. 240, 249, 274), *reprinted in* [2005–2006 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,510 (Dec. 21, 2005).

¹³ Proxy Working Group, NYSE, Inc., Report and Recommendations of the Proxy Working Group to the New York Stock Exchange 4 (June 5, 2006), http://www.nyse.com/pdfs/REVISED_NYSE_Report_6_5_06.pdf. The NYSE has adopted the proposal and filed it for SEC approval. Press Release, NYSE Group, NYSE Adopts Proxy Working Group Recommendation to Eliminate Broker Voting in 2008 (Oct. 24, 2006), available at <http://www.nyse.com/Frameset.html?nyseref=&displayPage=/press/1161166307645.html>.

¹⁴ See, e.g., Claudia H. Allen, Study of Majority Voting in Director Elections, at i–x (Feb. 5, 2007), http://www.ngelaw.com/files/upload/majority_callen_020707.pdf (revealing the increasing number of S&P 500 and Fortune 500 companies that have adopted majority voting provisions); General Motors Corp., Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year (Form 8-K), at exhibit 3.5 (Oct. 3, 2006), available at <http://www.sec.gov/Archives/edgar/data/40730/000004073006000045/0000040730-06-000045.txt> (disclosing GM's amendment of its bylaws to implement majority voting standard); see also Gretchen Morgenson, Big Board Delays Plan On Voting, N.Y. Times, Oct. 3, 2006, at C1 (reporting that “many companies, under pressure from shareholders, now require that directors receive a majority of the votes cast to be elected”).

¹⁵ Section 141(a) of the Delaware General Corporation Law provides that the “business and affairs of every corporation . . . shall be managed by or under the direc-

scribes might have adverse, unintended consequences, all in the name of “corporate democracy”—a term that is often misunderstood and misapplied.¹⁶

The risks of (a) “shaming” through withheld votes, precatory proposals, or criticism by stockholder service organizations like Institutional Shareholder Services (“ISS”) or investor-activists; or (b) lawsuits threatening personal liability for breach of fiduciary duty seem likely to have had a significant effect on directors’ incentives to enhance stockholder value. Fiduciary duty law, through the business judgment rule, better accounts for the risk taking that is necessary to optimize stockholder value.

Given Bebchuk’s proposed mass “removal trigger,” stockholders might be unduly reactive; they might vote out directors based on one deal gone bad when—from an ex ante, risk-reward perspective—doing the deal was appropriate or even optimal. If the goal is economic maximization, stockholder reactions that are not economically optimal (because they do not account for the risk that is necessary to achieving higher rewards) should not be encouraged or facilitated.

Furthermore, Bebchuk’s proposals do not solve the issue of stockholders’ underinvestment in director-election decisions. They also do not address the divergence between the goals institutional investors are pursuing when voting (short-term gains) and the goals of the underlying investors (long-term gains).¹⁷ Under Bebchuk’s proposal, institutional investors would still be the investors most

tion of a board of directors, except as may be otherwise provided” in the statute or corporate charter. Tit. 8, § 141(a).

¹⁶ See A. Gilchrist Sparks, III, *Corporate Democracy: What It Is, What It Isn’t, and What It Should Be*, *Insights*, Mar. 2006, at 20, 20 (“The term ‘corporate democracy’ is widely invoked by shareholder activists and others as a justification for change in the way we select directors of public corporations and the power we vest in those directors once we elect them. . . . However, because nations and business corporations are fundamentally different, to do so in a blanket and unconsidered fashion poses real dangers to corporations as long-term creators of wealth.”).

¹⁷ See Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk’s Solution for Improving Corporate America*, 119 *Harv. L. Rev.* 1759, 1765–66 (2006); cf. Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 *Harv. L. Rev.* 1735, 1754–55 (2006) (arguing that certain institutional investors pursue corporate governance changes whose benefits are not shared with other stockholders).

likely to propose an alternative slate, and their interests may not be aligned with those of the underlying or “long-term” stockholders.

Bebchuk correctly places substantial emphasis on improving directors’ incentives to increase stockholder value.¹⁸ But perhaps the threat of removal or nonelection does not advance that goal in light of recent governance improvements, or even strongly impact the incentives that are already there. Remarkably, Bebchuk argues that his proposal would not be disruptive because not that many firms would be affected. Does that not tend to show either that the current system works or that sweeping reform is not needed?

III. THE “DELICATE BALANCE” OF CORPORATE LAW IS WORKING

Central to Bebchuk’s many recent scholarly arguments and proposals for “reform” is the suggestion that the system of corporate law and the balance between board and stockholder power needs a massive renovation. For example, he has recently engaged in debate with other scholars on a variety of alleged ills in the system that, he says, warrant major structural reform.¹⁹ I respond here only to his “myth” argument on replacement of directors and his proposed reforms on this issue.²⁰

¹⁸ See Bebchuk, *supra* note 1, at 678–79.

¹⁹ Compare Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 *Harv. L. Rev.* 833, 837 (2005) (arguing that stockholders should be given “the power not only to elect and replace directors, but also to initiate and adopt rules-of-the-game decisions to amend the corporate charter or to reincorporate in another jurisdiction”), with Bainbridge, *supra* note 17 (questioning whether Bebchuk’s proposals would be efficient or meaningful), and Strine, *supra* note 17 (providing the “traditionalist” response to Bebchuk); compare also Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 *Bus. Law.* 43 (2003) (expressing support for the SEC’s shareholder access proposal), with Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company’s Proxy: An Idea Whose Time Has Not Come*, 59 *Bus. Law.* 67 (2003) (setting forth the main objections to and concerns about the shareholder access proposal), Robert C. Pozen, *Institutional Perspective on Shareholder Nominations of Corporate Directors*, 59 *Bus. Law.* 95 (2003) (suggesting institutional investors’ perspective on the shareholder access proposal), and Task Force on S’holder Proposals, *ABA Section of Bus. Law, Report on Proposed Changes in Proxy Rules and Regulations Regarding Procedures for the Election of Corporate Directors*, 59 *Bus. Law.* 109 (2003) (analyzing the shareholder access proposal).

²⁰ While I have views on his other proposals, I have resisted the temptation to articulate them here, except to note that any proposals for major change in corporate law require great care, assessment of real need, concern for unintended consequences, and respect for the delicate balance achieved by the current system. See Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 *Colum. L.*

We must recognize that American corporate law is nurtured in a delicately balanced “ecosystem”²¹ within our unique brand of federalism.²² This ecosystem balances three major components: (1) Delaware’s enabling statutory model, with a unique overlay of expert judicial case law; (2) within that system, the internal balance of the rights and responsibilities of the three main actors—stockholders, directors, and managers; and (3) the external balance between state law, which governs internal corporate affairs, and federal law, the proper role of which is limited to regulating markets.

Thus, while boards of directors take an active role in corporate affairs,²³ the role of stockholders has largely remained relatively passive and reactive. Recently, however, institutional investor activism has increased, and this activism, if pushed to an ultimate conclusion, may strengthen the stockholder franchise in a number of ways.

The increased activism of institutional investors can take many forms: jawboning, litigation, “withhold” campaigns targeting certain directors, and insinuation into the proxy process through stockholder proposals. The majority voting movement provides one recent example. Some investors have sought not only to assert precatory or binding proposals for majority voting, but also to amend corporate statutes to replace the default plurality standard

Rev. 1749 (2006) (discussing the role of such principles in Delaware corporate law-making).

²¹ E. Norman Veasey & Christine Di Guglielmo, *History Informs American Corporate Law: The Necessity of Maintaining a Delicate Balance in the Federal “Ecosystem,”* 1 Va. L. & Bus. Rev. 201 (2006).

²² See Melvin Aron Eisenberg, *The Architecture of American Corporate Law: Facilitation and Regulation*, 2 Berkeley Bus. L.J. 167, 176 (2005) (analyzing corporate law in terms of four modules: state statutory law, state judge-made law, federal law, and private ordering through “soft law”). For additional discussion of the state-federal balance in corporate law, see William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. Pa. L. Rev. 953 (2003); E. Norman Veasey et al., *Federalism vs. Federalization: Preserving the Division of Responsibility in Corporation Law*, in 2 *The Practitioner’s Guide to the Sarbanes-Oxley Act*, at V-5-1 (John J. Huber et al. eds., 2005).

²³ See Del. Code Ann. tit. 8, § 141(a) (2001) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . .”). Directors’ roles are also shaped by fiduciary-duty case law and modern best practices.

for the election of corporate directors with a default majority standard.²⁴ The proliferation of stockholder initiatives and the anticipated increase in bylaw proposals, coupled with greater facility for voting through the internet as well as other recent changes and proposals, make a massive change unnecessary, in my view.

IV. RECENT GOVERNANCE INITIATIVES DEMONSTRATE THAT PRIVATE ORDERING PROTECTS THE STOCKHOLDER FRANCHISE

One of Bebchuk's major premises is that "directors should not serve when more votes are cast against them than for them."²⁵ His use of the word "should" is important. I agree that this "should" be the correct course in most corporations. But whether it "must" happen in all corporations, and by what regime or authority, is the major question, in my view. The issue here—and for Bebchuk's other recent proposals, for that matter—is whether to make an about-face in the state law default provisions.²⁶

Over the past two or three years, there has been considerable discussion and some action on the optimal system of stockholder voting for the election of directors. This activity coincided with the inability of a majority of the SEC Commissioners to adopt a share-

²⁴ See, e.g., Comm. on Corporate Laws, ABA Section of Bus. Law, Changes in the Model Business Corporation Act—Proposed Amendments to Chapters 8 and 10 Relating to Voting by Shareholders for the Election of Directors, 61 *Bus. Law.* 399, 410 (2005); David C. McBride, Delaware Considers Majority Voting for Directors: Proposed Amendments to the Delaware General Corporation Law, *in* What All Business Lawyers & Litigators Must Know About Delaware Law Developments 2006, at 289, 297–98 (PLI Corporate Law & Practice, Course Handbook Series No. B-1543, 2006); Allen, *supra* note 14, at i (noting that "[o]ver 52% of the companies in the S&P 500 have adopted a majority vote policy, bylaw and/or charter provision, compared to fewer than 20% of the companies in that index" when the study began in February 2006).

²⁵ Bebchuk, *supra* note 1, at 701.

²⁶ After reading Bebchuk's proposals, I assume that he is urging a state law change and not a federal takeover of this aspect of state internal affairs law. For discussion of the actual or threatened federal takeover of corporate internal affairs, see, for example, Veasey et al., *supra* note 22; William W. Bratton & Joseph A. McCahery, The Equilibrium Content of Corporate Federalism, 41 *Wake Forest L. Rev.* 619 (2006); Sean J. Griffith & Myron T. Steele, On Corporate Law Federalism: Threatening the Thaumatrope, 61 *Bus. Law.* 1 (2005); Mark J. Roe, Delaware's Competition, 117 *Harv. L. Rev.* 588 (2003); Veasey & Di Guglielmo, *supra* note 21.

holder access rule that was proposed in 2003.²⁷ After the proposal was tabled, the debate turned to the question of whether majority voting should be the default rule under state law.

Delaware law and the Model Business Corporation Act (which is the frequently used template for state corporation law outside of Delaware) both provide for plurality voting as the default system for the election of directors.²⁸ Thus, in the absence of an opt-out, in an uncontested election the nominee chosen by the board of directors could be elected by a minority of the votes cast or, in theory, by a single vote.²⁹ Bebchuk argues that the statutory default should be changed to require a majority vote to elect a director in an uncontested election.³⁰

Under Delaware law, a corporation has for years been able to opt out of the statutory plurality default via amendment to the certificate of incorporation or the bylaws. Of course, an amendment to the certificate of incorporation requires both board and stockholder action, but an amendment to the bylaws usually may be accomplished by the board or the stockholders.³¹ Therefore, stockholders of a Delaware corporation could seek and achieve a bylaw amendment permitting majority voting or some other nonplurality standard without director involvement. Under the Model Act, however, the only permissible method of opting out of the plurality

²⁷ Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, and 274), *reprinted in* [2003–2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,101 (Oct. 23, 2003).

²⁸ See Del. Code Ann. tit. 8, § 216(3) (2001); Comm. on Corp. Laws, ABA Section of Bus. Law, Changes in the Model Business Corporations Act—Amendments to Chapter 7 and Related Provisions Relating to Shareholder Action Without a Meeting, Chapters 8 and 10 Relating to Shareholder Voting for the Election of Directors, and Chapter 13 Relating to Appraisal and Other Remedies for Fundamental Transactions, 61 Bus. Law. 1427, 1432 (2006).

²⁹ The background and the operative provisions of both the Delaware General Corporation Law and the Model Act are described in the Report of the ABA Committee on Corporate Laws recommending changes in the Model Act. See Comm. on Corp. Laws, ABA Section of Bus. Law, *supra* note 24, at 404–07; Comm. on Corp. Laws, ABA Section of Bus. Law, *supra* note 28, at 1432–36.

³⁰ See Bebchuk, *supra* note 1, at 702–03.

³¹ See tit. 8, § 109(a) (empowering stockholders to “adopt, amend or repeal bylaws” and permitting the corporation to authorize the directors to do so).

default system had been through amendment to the articles of incorporation (and not the bylaws).³²

Delaware law and the Model Act were amended in 2006 to facilitate and strengthen stockholder-empowering private ordering. Delaware law now (a) provides that the board may not undo a stockholder-adopted bylaw in this area; and (b) permits a director's resignation to be irrevocable when the director is implementing a policy (increasingly prevalent among boards of directors) requiring a director to tender her resignation in the event she does not secure a majority of votes cast in an uncontested election.³³

The Model Act now also allows a corporation to implement, through private ordering, a form of majority voting. In 2006, the Committee on Corporate Laws adopted amendments to the Model Act that permit either the board or the stockholders of a corporation to adopt a limited, but carefully constructed, bylaw establishing majority voting in an uncontested election; a director who receives "more votes against than for" will not be elected for a full term, but will serve for only ninety days unless the board, in "consideration of their duties," determines that the director should be seated for a full term.³⁴

The Delaware lawmakers and the ABA Committee on Corporate Laws decided not to propose a majority voting standard as a new default rule. Central to the decisions of both groups not to change the default rule to majority voting was that changing the default on a one-size-fits-all basis might cause unintended consequences in the case of a "failed election." Changing the statutory default from "plurality" to "majority" would impose a one-size-fits-all rule on all corporations. In some cases, the particular cir-

³² See Model Bus. Corp. Act Annot. § 7.28 (3d ed. 2002).

³³ An Act to Amend Title 8 of the Delaware Corporate Code Relating to the General Corporation Law, Public Act No. 306, §§ 3, 5 (June 27, 2006), 2006 Del. ALS 306 (LexisNexis) (amending §§ 141(b) and 216 of title 8 of the Delaware Code relating to the General Corporation Law).

³⁴ See Comm. on Corp. Laws, ABA Section of Bus. Law, *supra* note 28, at 1432–35 (reporting the June 2006 amendment to § 10.22 of the Model Business Corporation Act); *id.* at 1430–31 (reporting the June 2006 amendments to §§ 8.05 and 8.07 of the Model Act). Note that the Model Act amendments have been adopted but require enactment by a state legislature in order to be effective in that state.

cumstances of a given corporation could lead to real problems if majority voting resulted in a failed election.³⁵

In contrast, facilitating private ordering through adoption of a voting bylaw will enable the stockholders of a particular corporation to determine whether those potential consequences apply and, if so, whether the governance change is worth the risk. Further, as a result of the 2006 amendment, directors may not undo a majority voting bylaw approved by stockholders.³⁶ Thus, once stockholders take action in this area, it will “stick” unless the stockholders themselves repeal the change.

Recent activity at the federal level also may work to enhance stockholder power. For example, many proper stockholder-proposed bylaws relating to systems for electing directors might now be included in a company’s proxy materials.³⁷ Very recently, in *American Federation of State, County & Municipal Employees v. American International Group*, the United States Court of Appeals for the Second Circuit undertook an important analysis of Rule 14a-8.³⁸ In the case, a stockholder (AFSCME) sought to have the issuer (AIG) include in its proxy statement a proposal that would amend the AIG bylaws to require AIG, under certain circumstances, to publish in its proxy statement the names of stockholder-

³⁵ See Comm. on Corporate Laws, ABA Section of Bus. Law, *supra* note 24, at 410–11 (detailing the potential consequences of a failed election). Ironically, proposals to amend the default rules simply to substitute “majority” for “plurality,” without more, could result in a Pyrrhic victory because of the holdover rule, see Comm. on Corp. Laws, ABA Section of Bus. Law, *supra* note 28, at 1430 (Model Bus. Corp. Act § 8.05(e), as amended); tit. 8, § 141(b), that would permit incumbents who do not receive a majority vote to stay in office until replaced by a successor who did achieve election by a majority vote.

³⁶ An Act to Amend Title 8 of the Delaware Corporate Code Relating to the General Corporation Law § 5 (amending § 216 of title 8 of the Delaware Code relating to the General Corporation Law).

³⁷ Rule 14a-8 under § 14 of the 1934 Act is the central rule governing what an issuer may or must include in its proxy statement. An issuer that receives a stockholder proposal seeking inclusion in the company’s proxy statement for the purpose of garnering votes must decide if it wishes to include the proposal or to seek approval from the SEC to exclude the proposal. Such “approval” generally comes in the form of a no-action letter from the Commission Staff stating that the SEC will not take action against the issuer if the proposal is excluded from the proxy statement. One of the key provisions of Rule 14a-8 is Rule 14a-8(i)(8), which provides that an issuer may exclude from its proxy statement any proposal that “relates to an election.” 17 C.F.R. § 240.14a-8 (2006).

³⁸ 462 F.3d 121 (2d Cir. 2006).

nominated director candidates, along with any candidates nominated by the board.

The court held that “a shareholder proposal that seeks to amend the corporate bylaws to establish a procedure by which shareholder-nominated candidates may be included on the corporate ballot does not relate to an election within the meaning of the Rule and therefore cannot be excluded from corporate proxy materials under that regulation.”³⁹ Specifically, the court interpreted Rule 14a-8’s election exclusion as “applying to shareholder proposals that relate to a particular election and not to proposals that, like AFSCME’s, would establish the procedural rules governing elections generally.”⁴⁰

The Second Circuit’s interpretation of Rule 14a-8 reverses the interpretive approach to the rule that the SEC Staff has taken for the past decade or so, although the SEC’s approach has been inconsistent since the rule was promulgated in 1976.⁴¹ This type of by-law is a form of private ordering that may achieve the “Holy Grail” of access and, like a majority voting opt-out, is permitted under state law.

To his credit, Bebchuk has taken the position that stockholder proposals which are permitted by state law should not be excluded from the company’s proxy. In fact, he joined with other Harvard professors in writing an amicus curiae brief in the *AFSCME* case urging the outcome that the Second Circuit ultimately adopted. It is now important, in my view, for the SEC to undertake a comprehensive review of Rule 14a-8 and to consider a clearer set of rules. Indeed, the Commission has announced its intention to do just that.⁴² Central to that consideration must be proper deference to

³⁹ Id. at 123.

⁴⁰ Id. at 130.

⁴¹ A review of no-action letters issued by the SEC reveals that the SEC has intermittently reversed course on this issue. See id. at 128 (collecting no-action letters reflecting the SEC’s various interpretive approaches).

⁴² The Commission will consider recommendations by the Staff on at least an amendment to Rule 14a-8 concerning director nominations by shareholders. Press Release, SEC, Commission Calendars Proposed Amendment to Rule 14a-8 Governing Director Nominations by Shareholders (Sept. 7, 2006), available at <http://www.sec.gov/news/press/2006/2006-150.htm>; see also Press Release, SEC, Commission Announces Schedule for Action Regarding Section 404 of the Sarbanes-Oxley Act of 2002, Foreign Private Issuer Deregistration, Internet Availability of Proxy Materials, and Securities Exchange Act Rule 14A-8 (Oct. 11, 2006), available at

principles of federalism where the SEC must decide when matters permitted by state law must be allowed to go to a stockholder vote.

Other recent federal activity will also facilitate stockholders' ability to exercise their voting rights. For example, in December 2005, the SEC released a proposed rule that, if adopted, will allow proxy materials to be provided via the internet.⁴³ This will lower the cost of proxy contests, enhancing stockholders' ability to put forth alternative board candidates or make other proposals.⁴⁴

Furthermore, if implemented, the NYSE's broker nonvote proposal⁴⁵ will also enhance stockholder power. The proposal recommends amending the NYSE's Rule 452 to make the election of directors a "non-routine" matter.⁴⁶ Thus, brokers would no longer be permitted to vote on the election of directors for shares they hold for beneficial owners without receiving instructions from the beneficial owners regarding how to vote the shares.⁴⁷ The NYSE working group observed:

Investors, courts, regulators and others expect directors to be accountable for the corporate decision-making process, and the primary way that accountability is expressed is through the director election process. . . . [Thus,] the election of directors should no longer be viewed as routine under Rule 452 and . . . brokers should no longer be permitted to cast uninstructed shares for the election of directors.⁴⁸

<http://www.sec.gov/news/press/2006/2006-172.htm> (announcing that the Commission would consider the Rule 14a-8 issue at an open meeting scheduled for December 13, 2006). The issue was not discussed at the December 13 meeting, however, and the SEC has not yet announced plans to consider the issue in the future. I trust that the Commission will take a comprehensive look at the entire spectrum of shareholder proposals under Rule 14a-8 so as to develop a clear and rational system.

⁴³ Internet Availability of Proxy Materials, *supra* note 12.

⁴⁴ *Id.* at 74,612.

⁴⁵ Proxy Working Group, NYSE, *supra* note 13. The NYSE recently adopted the proposal and filed it for approval by the SEC. If amended, the proposal will be effective for all stockholder meetings held on or after January 1, 2008. See Press Release, *supra* note 13.

⁴⁶ Proxy Working Group, NYSE, *supra* note 13, at 3-4.

⁴⁷ Rule 452 authorizes brokers to vote for stock held for beneficial owners if the beneficial owners do not provide instructions at least ten days before the stockholders' meeting regarding how to vote and the matter subject to the vote is "routine." See *id.* at 7 (discussing the so-called "Ten Day Rule").

⁴⁸ *Id.* at 21.

Proposals such as the SEC's internet voting rule and the NYSE's broker nonvote rule will, if implemented, meaningfully enhance the stockholder franchise. Sweeping changes to the statutory framework of corporate law are therefore not needed at this time.

Finally, in addition to majority voting, there may be areas under state law where bylaw changes initiated by stockholders may accomplish many of Bebchuk's goals through private ordering, rather than through wrenching statutory changes.⁴⁹ Stockholders have broad power to amend bylaws,⁵⁰ and bylaws "may contain any provision for managing the business and regulating the affairs of the corporation that is not inconsistent with law or the articles of incorporation."⁵¹ In addition, under the Model Act, stockholders may prohibit the board from amending or repealing a stockholder-adopted bylaw.⁵² Thus, stockholders have substantial opportunities to enact bylaws to implement some of Bebchuk's proposals, such as confidential voting or reimbursement of expenses.

If effected by private ordering—whether through stockholder-proposed bylaws, changes in the certificate of incorporation, or director-proposed bylaws—Bebchuk's proposals, such as confidential voting or reimbursement of expenses, are not objectionable. Indeed, they will reflect corporate constituents' assessment of the best course for the corporation, taking into account the corporation's unique circumstances. But changing the statutory default

⁴⁹ Cf. Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 *Tul. L. Rev.* 409, 417 (1998) (exploring "the appropriate contours of stockholder-adopted by-laws that limit director authority" and "their ability to withstand nullification by director action").

⁵⁰ Del. Code Ann. tit. 8, § 109(a) (2001); Model Bus. Corp. Act § 10.20 (2005).

⁵¹ Model Bus. Corp. Act § 2.06(b); see also tit. 8, § 109(b) ("The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.").

⁵² Model Bus. Corp. Act § 10.20(b) (providing that the board of directors may not amend or repeal a bylaw if "the shareholders in amending, repealing, or adopting a bylaw expressly provide that the board of directors may not amend, repeal, or reinstate that bylaw"). Except with respect to stockholder-adopted bylaws relating to the number of votes required to elect a director, the Delaware statute does not expressly limit directors' power to amend or repeal a stockholder-adopted bylaw, but equitable considerations may prevent them from doing so. See *Schnell v. Chris-Craft Indus.*, 285 A.2d 437, 439 (Del. 1971) ("[I]nequitable action does not become permissible simply because it is legally possible.").

2007] *The Stockholder Franchise Is Not a Myth* 825

rules on a one-size-fits-all basis is potentially mischievous as well as unnecessary, in my view.

CONCLUSION

We should avoid making unnecessary changes in statutory law. Such changes are inefficient and create uncertainty and instability. Statutory law, by its nature, cannot take account of the wide range of characteristics and circumstances of various corporations. Thus, private ordering remains the most flexible and best approach to protecting stockholder power.

This private ordering is permitted under the current default rules of the Delaware corporation law and the Model Act. Recent progress on majority voting and a variety of other governance issues demonstrates that Bebchuk's proposals are not needed for the realization of stockholder power. His goals can be achieved through private ordering in corporate bylaws, and the recent changes demonstrate that sufficient momentum can be gathered to do so, if the changes are in fact desirable.