Note

Rule 14a-11 and the Administrative Procedure Act: It's Better to Have Had and Waived, than Never to Have Had at All

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A dramatic sequence of events starting in the summer of 2007 caused the United States' banking and financial systems to collapse and thrust the country into the worst financial crisis since the Great Depression.[1] It was not just one thing, but a confluence of factors that led to the collapse and the resultant crisis.[2] Of particular note, though, commentators have pointed to risky lending coupled with inadequate personal savings,[3] collateralized debt obligations backed by subprime mortgages,[4]

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1. RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION, at vii (2009); *see also* Jon Hilsenrath, Serena Ng & Damian Paletta, *Worst Crisis Since '30s, with No End in Sight*, WALL ST. J., Sept. 18, 2008, at A1.

2. *See* POSNER, *supra* note 1, at vii, 75–76.

3. *Id.* at 75; *see also* Robert T. Miller, *The Board's Duty to Monitor Risk After* Citigroup, 12 U. PA. J. BUS. L. 1153, 1153 (2010) ("Across the ideological spectrum, from Paul Krugman to Richard Posner and from Lucien [sic] Bebchuk to Stephen Bainbridge, commentators agree that one of the main causes of the financial crisis was that banks took on too much risk." (footnotes omitted)).

4. *See* William Poole, *Causes and Consequences of the Financial Crisis of 2007–2009*, 33 HARV. J.L. & PUB. POL'Y 421, 424–26 (2010). Several commentators have noted the important role that collateralized debt obligations played in the financial crisis. *See generally* MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010) (discussing at length collateralized debt obligations and their role in causing the financial crisis); Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 394–98 (2008) (discussing how the market for collateralized debt obligations backed by subprime mortgages affected other asset-backed securities).

and flawed economic and monetary policy[5] as the driving forces of the crisis. The causes of the crisis, however, were not solely the underlying fundamentals of the market, but also its participants. To be sure, chief executive officers (CEO) and other corporate and institutional managers, whose recklessness and excessive risk taking allowed the crisis to burgeon, have taken the brunt of the criticism.[6] But commentators have also attacked boards of directors—tasked with overseeing some of the United States' largest corporations—for failing to monitor closely the immoderation of corporate officers, and thereby letting down the shareholders of U.S. corporations.[7] The notion, however, that some boards do not satisfactorily govern their respective corporations is not unique to the recent financial crisis,[8] nor is the idea that the prerogative of shareholders can be, and often is, ignored.[9] Disney's 2004 shareholder vote for its board of directors has become emblematic of this latter contention.[10]

5. Heidi Mandanis Schooner, *Private Enforcement of Systemic Risk Regulation*, 43 CREIGHTON L. REV. 993, 993 (2010) (stating that "sustained ultra-low interest rates" were a contributing factor to the financial crisis).

6. *See The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight and Governmental Reform*, 110th Cong. 12 (2008) (statement of Alan Greenspan, former Chairman, Federal Reserve Board) (expressing "shocked disbelief" in the actions of sophisticated market participants in the lead up to the financial crisis); Letter from Warren Buffett, Chairman of the Bd., Berkshire Hathaway Inc., to Shareholders of Berkshire Hathaway Inc. 16 (Feb. 26, 2010), *available at* http://www.berkshirehathaway.com/letters/2009ltr.pdf (castigating both corporate officers and directors for failing to control risk); Sam Gustin, *As Berkshire Returns to Form, Buffett Blasts Wall Street*, DAILYFINANCE.COM, (Feb. 27, 2010, 5:45 AM), http://www.dailyfinance.com/story/company-news/as-berkshire-returns-to-profitability-buffett-blasts-wall-stree/19376483/ (commenting on Buffett's 2009 letter to Berkshire Hathaway's shareholders).

7. *See, e.g.*, JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 52 (2008) (arguing that the virtual plenary power of boards to manage the business and affairs of a corporation necessarily makes them the natural focus of inquiry during times of economic crisis).

8. *See* JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 2 (1989) (contending that boards of directors, as much as corporate officers, were responsible for the "obvious malaise" of business performance in the United States during the 1980s).

9. *See, e.g.*, Thomas Joo, *Global Warming and the Management-Centered Corporation*, 44 WAKE FOREST L. REV. 671, 673 (2009) (describing the limitations on shareholders' powers).

10. *See* Tara L.C. Van Ho, Comment, *Reconstructing the Marriage of Ownership and Control: Is the SEC Missing an Important Step in Its Hesitancy to Adopt Proposed Rule 14a-11?*, 73 U. CIN. L. REV. 1211, 1211 (2005).

Although he successfully brought Disney back from the brink of disaster in the 1980s, Michael Eisner, Disney's CEO, thereafter engaged in ill-advised ventures and "obsessive micro-management," which resulted in declining share prices and unhappy employees.[11] In 2004, forty-three percent of Disney's shareholders, in a previously unheard of show of dissent, "withheld" their votes from Eisner in the election for Disney's board of directors.[12] This percentage represented "an unambiguous message of unhappiness" with Eisner.[13] Nevertheless, the board, unanimous in its support for Eisner, voted to retain him as CEO of the company.[14]

Both the financial crisis and Disney's example have resulted in continued public demand for greater regulation and oversight of America's corporate boardrooms.[15] Efforts to increase shareholder power over the corporations they own—primarily through their votes on proxy statements at annual shareholder meetings—have thus been at the forefront of debates on corporate governance.[16] Taking a lead role in the debate, on August 25, 2010, the Securities and Exchange Commission (SEC) adopted Rule 14a-11.[17]

The SEC, empowered by Congress under the Securities Act of 1933[18] and the Securities Exchange Act of 1934 (Exchange Act),[19] serves to protect investors against unscrupulous boards

11. Ronald Grover & Tom Lowry, *Now It's Time to Say Goodbye: How Disney's Board Can Move Beyond the Eisner Era*, BUS. WK., Mar. 15, 2004, at 30, 31.

12. Van Ho, *supra* note 10, at 1211 (discussing the Disney shareholder vote). In a system of plurality voting, as Disney had, a candidate can win with less than fifty percent of the vote, and there is no option to vote "no." Thus, shareholders, as a sign of dissent, "withhold" their vote for any particular candidate; Grover & Lowry, *supra* note 11, at 31. D. GORDON SMITH & CYNTHIA A. WILLIAMS, BUSINESS ORGANIZATIONS: CASES, PROBLEMS, AND CASE STUDIES 462–63 (2008).

13. Grover & Lowry, *supra* note 11, at 31.

14. *Id.*

15. *See* Letter from David Prystal to Nancy Morris, Sec'y, SEC (Sept. 21, 2007), *available at* http://www.sec.gov/comments/s7-17-07/s71707-30.htm.

16. *Compare* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006) (arguing against increased shareholder power), *with* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (arguing for greater shareholder power).

17. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

18. Pub. L. No. 73-22, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a–77aa (2006 & Supp. II 2009)).

19. Pub. L. No. 73-291, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a–78oo (2006 & Supp. II 2009)).

of directors and corporate officers.[20] Pursuant to its congressional mandate, the SEC promulgated Rule 14a-11, which "require[s], under certain circumstances, a company's proxy materials to provide shareholders with information about, and the ability to vote for, a shareholder's, or group of shareholders', nominees for director."[21] With certain conditions, the Rule effectively ends management's monopoly over the corporate proxy statement.[22]

The Rule also imposes on the states and unwilling majorities of shareholders a mandatory federal scheme.[23] Dubbed a "Mandatory Minimum Access Regime"[24] by Professor Joseph Grundfest, the Rule permits shareholders to pass access standards that allow for greater access for shareholders to nominate directors, but condemns any shareholder effort to provide for less access.[25] The Rule thus suggests that shareholders, though presumed to be sufficiently intelligent and responsible to nominate and elect their own directors, are not "sufficiently intelligent and responsible . . . to determine whether proxy access should apply at any particular corporation."[26] Such a blatant contradiction, Grundfest and others argue, renders Rule 14a-11 "arbitrary [and] capricious" under the Administrative Procedure Act (APA),[27] and thus invalid.[28]

20. *See* 15 U.S.C. § 78n(a) (2006).

21. Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,668 (stating that Rule 14a-11 "will require" a company to include qualifying shareholders' nominees for the board).

22. Letter from Gerald W. McEntee, Int'l President, Am. Fed'n of State, Cnty. & Mun. Emps., to Elizabeth M. Murphy, Sec'y, SEC 1 (Aug. 7, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-88.pdf.

23. Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,673.

24. Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUS. LAW. 361, 368 (2010) [hereinafter Grundfest, *Proposed Proxy Access Rules*]; *see also* Joseph A. Grundfest, *Internal Contradictions in the SEC's Proposed Proxy Access Rules* 1 (Rock Ctr. for Corporate Governance, Working Paper No. 60, 2009), *available at* http://ssrn.com/abstract=1438308, *attached to* Letter from Joseph A. Grundfest, William A. Franke Professor of Law & Bus., Stanford Law Sch., to Elizabeth M. Murphy, Sec'y, SEC (July 24, 2009), *available at* http://sec.gov/comments/s7-10-09/s71009-64.pdf [hereinafter Grundfest, *Internal Contradictions*].

25. Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,680 ("[W]e are not persuaded that we should allow our rules to be altered by shareholders or boards to the potential detriment of other shareholders.").

26. Grundfest, *Proposed Proxy Access Rules*, *supra* note 24, at 370.

27. 5 U.S.C. § 706(2)(A) (2006) ("[T]he reviewing court shall . . . hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary [and] capricious . . . .").

28. *See* Grundfest, *Proposed Proxy Access Rules*, *supra* note 24, at 364.

This Note advocates for a different interpretation of Rule 14a-11 and argues that the Rule is not inherently contradictory and thus not arbitrary and capricious under the APA. Part I of this Note sets forth the historical and legal background behind the enactment of Rule 14a-11. Part II dissects the case for increasing shareholder rights and analyzes Rule 14a-11 under common-law arbitrary and capricious standards. Finally, Part III proposes a judicial resolution in favor of Rule 14a-11 or, in the alternative, urges that the SEC amend the Rule to include parameters within which shareholders can tailor the level of access that is most beneficial to their respective corporations.

I. THE AMERICAN SYSTEM OF CORPORATE GOVERNANCE

Issues of corporate governance[29] have been at the forefront of corporate law for years.[30] Most contentious is the debate about the role shareholders should play in framing and influencing the business and affairs of America's largest corporations.[31] The SEC recently turned up the heat in this debate by adopting Rule 14a-11.[32] This Part discusses the issues and law surrounding the debate in three sections. First, it looks at the ever-increasing divide between ownership and control in the modern corporation and its effects on corporate governance. Second, this Part addresses the SEC's promulgation of proxy rules pursuant to its congressional mandate and the role of those rules in the current debate. Finally, this Part looks at Rule 14a-11 and its relation to the APA's arbitrary and capricious standard.

A. THE DIVIDE BETWEEN OWNERSHIP AND CONTROL

In 1932, Adolf Berle and Gardiner Means examined the division between the ownership and management of American

29. Corporate governance, though a "hefty-sounding phrase," simply concerns the "oversight of a company's management." Judith Burns, *Corporate Governance (A Special Report)—Everything You Wanted to Know About Corporate Governance . . . But Didn't Know to Ask*, WALL ST. J., Oct. 27, 2003, at R6.

30. *See supra* note 16 and accompanying text.

31. *See generally* James McConvill, *Shareholder Empowerment as an End in Itself: A New Perspective on Allocation of Power in the Modern Corporation*, 33 OHIO N.U. L. REV. 1013 (2007) (discussing at length the debate over the costs and benefits of increased shareholder empowerment).

32. *Cf.* Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 260–61 (2005) (discussing the debate surrounding the SEC's 2003 proposal of Rule 14a-11).

corporations.[33] Berle and Means's data demonstrated two truths. First, the modern corporation of the twentieth century was no longer the "mom-and-pop" business of the nineteenth century, but rather had become a complex entity composed of thousands of workers and extensive property holdings worth millions of dollars.[34] Second, ownership was not concentrated in a single individual, but rather belonged to a diffuse network of shareholders.[35] Relying on these two findings, Berle and Means concluded that control of the corporation would inevitably diverge away from the owners and towards centralized management.[36] Shareholders, in effect, accepted ownership of the corporation's stock, but gave up the right to control the direction of that property.[37] Shareholders, therefore, have come to possess "passive property," and are thus passive investors, having ceded control of the corporation to the board of directors.[38]

The board's power to manage the business and affairs of the corporation is almost plenary.[39] In Delaware, the leading source of corporate law in the United States,[40] "a cardinal precept of [corporate law] is that directors, rather than shareholders, manage the business and affairs of the corporations."[41]

33. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

34. *See id.* at 2–3 (contrasting small businesses of the nineteenth century with the "great aggregations" of wealth and property of corporations at the turn of the century).

35. *See id.* at 3 (describing the American Telephone and Telegraph Company, which had over 500,000 shareholders at that time).

36. *Id.* at 6.

37. *See* Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, but Not Too Late*, 43 AM. U. L. REV. 379, 384 (1994).

38. *See* BERLE & MEANS, *supra* note 33, at 346–47; *see also* Goforth, *supra* note 37, at 384 (summarizing Berle and Means's arguments).

39. Bainbridge, *supra* note 16, at 616 ("In U.S. corporate law, shareholder control rights in fact are so weak that they scarcely qualify as part of corporate governance."); Minor Myers, *The Decisions of the Corporate Special Litigation Committees: An Empirical Investigation*, 84 IND. L.J. 1309, 1312 (2009).

40. *E.g.*, ROBERT W. HAMILTON & RICHARD A. BOOTH, CORPORATION FINANCE: CASES AND MATERIALS 873 (3d ed. 2001) ("Delaware . . . is the principal architect and steward of a 'national corporation law' since it is the domicile of over 180,000 corporations . . . ." (quoting E. Norman Veasey et al., *The Delaware Takeover Law: Some Issues, Strategies and Comparisons*, 43 BUS. LAW. 865, 866 (1988))).

41. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984); *see also* DEL. CODE ANN. tit. 8, § 141(a) (2009) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ."); Paramount Commc'ns Inc. v. QVC Network Inc. (*In*

Similarly, the Model Business Corporation Act, adopted by roughly half the states,[42] provides the board of directors with nearly absolute power to manage the business and affairs of the corporation.[43] Adding an additional layer, courts have taken a very deferential stance towards boards' power to make business decisions.[44] The business judgment rule, first instituted nearly two centuries ago,[45] cautions courts to exercise restraint in second-guessing a board's business decision.[46] Simply stated, the rule provides a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[47] Justified, in part, on the ground of keeping judges inexperienced in business from interfering,[48] the rule effectively clothes boards of directors with virtually unlimited power to steer corporations in whatever directions they see fit.[49]

There are inherent difficulties associated with the stark divide between shareholder ownership and director control in the modern corporation. Of great concern is the possible devolution of the long-established "shareholder primacy" norm[50]—namely, the notion that directors are to make decisions in the

re Paramount Commc'ns Inc. S'holders' Litig.), 637 A.2d 34, 41–42 (Del. 1993) ("[It is a] fundamental principle that the management of the business and affairs of a Delaware corporation is entrusted to its directors, who are the duly elected and authorized representatives of the stockholders.").

42. *See* Lisa M. Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 OHIO ST. L.J. 53, 63 (2008).

43. *See* MODEL BUS. CORP. ACT § 8.01(b) (2002).

44. *See, e.g.*, Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 928 (Del. 2003) ("The business judgment rule embodies the deference that is accorded to managerial decisions of a board of directors.").

45. Percy v. Millaudon, 8 Mart. (n.s.) 68, 78 (La. 1829) ("The test of responsibility therefore should be, not the certainty of wisdom in others, but the possession of ordinary knowledge; and by shewing that the error of the agent is of so gross a kind, that a man of common sense, and ordinary attention, would not have fallen into it.").

46. *See* FRANKLIN A. GEVURTZ, CORPORATION LAW 278–79 (1st ed. 2000) (discussing the rationale underlying the business judgment rule).

47. Unocal Corp. v. Mesa Petroleum, Co., 493 A.2d 946, 954 (Del. 1985) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

48. SMITH & WILLIAMS, *supra* note 12, at 502.

49. *See* Gimbel v. Signal Cos., 316 A.2d 599, 608 (Del. Ch. 1974) (holding that the business judgment rule starts with a presumption in the board's favor).

50. *See* Usha Rodrigues, *Let the Money Do the Governing: The Case for Reuniting Ownership and Control*, 9 STAN. J.L. BUS. & FIN. 254, 254–55 (2004) (questioning whether boards always work to serve the interests of shareholders).

interests of the shareholders.[51] Unfortunately, because shareholders cannot expect the management of the modern corporation to monitor their property "with the same anxious vigilance" that private partners would their own,[52] the difficulty becomes more apparent.

B. THE AMERICAN PROXY SYSTEM

Recognizing these difficulties, Congress enacted the Exchange Act[53] in an effort to provide more and better information to shareholders so they can assert control over the corporations they own.[54] Generally, the Exchange Act seeks to prevent corporations from misleading shareholders by mandating that boards of directors provide a greater degree of disclosure in annual proxy statements.[55] More specifically, section 14(a) of the Exchange Act, in light of the ever-increasing diffusion of shareholders,[56] authorizes the SEC to promulgate rules for shareholder voting by proxy.[57]

The rules promulgated under section 14(a) and adopted by the SEC have sought to institutionalize shareholders' voting rights.[58] Long understood by Congress as an important right,[59]

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51. *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."); *see also* John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1327 (1992) ("The traditional shareholder primacy model of the corporation derives from the concept that the shareholders are the owners of the corporation and, as such, are entitled to control it, determine its fundamental policies, and decide whether to make fundamental shifts in corporate policy and practice.").

52. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 700 (Edwin Cannan ed., Random House, Inc. 1965); *see also* BERLE & MEANS, *supra* note 33, at 345–46 (commenting on Smith's argument).

53. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (current version codified at 15 U.S.C. §§ 78a–78oo (2006 & Supp. II 2009)).

54. *See id.* at 895; *see also* GEVURTZ, *supra* note 46, at 242 (contending that it is not a coincidence that Congress passed the Securities Act and Exchange Act two years after Berle and Means authored *The Modern Corporation and Private Property*).

55. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) ("A fundamental purpose [of the Exchange Act] . . . was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* . . . .").

56. *See* Fairfax, *supra* note 42, at 60 (commenting on the need for proxy votes to take into account the widely dispersed nature of public shareholders).

57. 15 U.S.C. § 78n (2006).

58. *See, e.g.*, 17 C.F.R. § 240.14a-3 (2008) (outlining the information to be furnished to shareholders in a proxy statement).

the SEC wanted to formalize those rights and thereby erase the "monarchial [and] aristocratic" climate of U.S. corporate boardrooms.[60] The SEC's purpose in establishing shareholders' voting power was twofold: to give shareholders a direct say in elections, and to give shareholders an indirect influence over director behavior, thereby increasing the chances that directors would listen to shareholder concerns when making business decisions.[61] In effect, the SEC hoped to imbue shareholders with greater control over the corporations they own, allowing them to play a greater role in the decisionmaking process.[62] The proxy rules, unfortunately, failed to achieve this goal.[63] Instead, the SEC left boards with significant power to control the direction of their corporations: the power to be effectively the sole guardians of the director nomination process.[64]

Proxy Rule 14a-4(b)(2) outlines the form of proxy necessary for the election of directors.[65] It plainly states that the proxy "shall set forth the names of persons nominated for election as directors."[66] The issue is that the proxy rules do not require the names of all candidates for the board to be on a corporation's proxy statement, but only those candidates whom the releasing party—the corporation—supports.[67] The board can choose to include shareholders' nominees for director,[68] but boards rarely do so.[69] Thus, shareholders must resort to the few measures available to them in the rules to nominate their own candidates or effectuate board action.

59. *See* H.R. REP. NO. 73-1383, at 14 (1934).

60. *Id.* at 5.

61. *See* Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1261 (2009).

62. *See* H.R. REP. NO. 73-1383, at 14.

63. *See* Goforth, *supra* note 37, at 388.

64. *See id.*; *see also* Lynne L. Dallas, *The Control and Conflict of Interest Voting Systems*, 71 N.C. L. REV. 1, 19 (1992) ("Although shareholders have the right to elect directors, the federal proxy rules do not permit shareholders to nominate them for inclusion in the corporation's proxy statement.").

65. 17 C.F.R. § 240.14a-4(b)(2) (2010).

66. *Id.*

67. *See* GEVURTZ, *supra* note 46, at 247–48 (rejecting the proposition that a proxy statement is analogous to a ballot in a democratic election, preferring to liken it instead to an old Soviet Union ballot in which electors would simply vote yes or no to the Communist Party's nominated candidate).

68. *See, e.g.*, Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U. L. REV. 37, 38 (1990) (noting that boards or nominating committees may, but are not required to, include shareholders' nominees).

69. McDonnell, *supra* note 32, at 211.

Under the proxy rules and corporate law, there are at least three available mechanisms for shareholders to bring into effect board action in this area. Shareholders may take the so-called Wall Street Walk;[70] engage in a proxy contest to submit their own proxy to the shareholders;[71] or submit a bylaw amendment proposal that requires the board to include shareholder nominees in the corporation's proxy materials.[72] None of these measures has proven successful in increasing shareholders' rights to nominate their own slate of candidates.

First, the Wall Street Walk, or the Wall Street rule, essentially holds that shareholders can "vote with their feet" by selling their stock when they are dissatisfied with a board's decisions.[73] There are evident problems with the Wall Street rule, however. Broadly speaking, the Wall Street rule overlooks "the fact that it leads to high turnover of stock ownership."[74] Such turnover has two effects: it fosters increased unpredictability in the capital markets and it forces management to focus on short-term profits, as opposed to better quality long-term results.[75] More narrowly, the Wall Street rule does nothing for individual shareholders seeking to change corporate governance schemes or nominate a director.[76]

Second, shareholders can nominate their own slate of directors by engaging in a proxy contest.[77] Commentators have generally defined a proxy contest as a "struggle between two or more opposing groups for minority representation or majority control of a corporation's board of directors through the solicitation of proxies."[78] To engage in a proxy contest, a shareholder, unlike an incumbent whose costs are fully borne by the corporation, must assume enormous procedural expense.[79] At the least, a shareholder must pay to prepare a proxy statement,

70. *See* Jayne Elizabeth Zanglein, *From Wall Street Walk to Wall Street Talk: The Changing Face of Corporate Governance*, 11 DEPAUL BUS. L.J. 43, 46 (1998).

71. *See* McDonnell, *supra* note 32, at 211.

72. *See id.*

73. Van Ho, *supra* note 10, at 1220.

74. Goforth, *supra* note 37, at 407.

75. *See id.*

76. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 716 (2007).

77. HAMILTON & BOOTH, *supra* note 40, at 762–63.

78. DOUGLAS V. AUSTIN, PROXY CONTESTS AND CORPORATE REFORM 3 (1965) (emphasis omitted).

79. Bebchuk, *supra* note 16, at 856; Bebchuk, *supra* note 76, at 688–89 (discussing the costs associated with a proxy contest).

mail each proxy card to individual shareholders, and defend against the incumbents' legal challenges to the accuracy or completeness of the proxy statement.[80] These costs, most notably in the case of large corporations, can force a shareholder to pay hundreds of thousands, if not millions, of dollars.[81] Consequently, proxy contests are exceedingly rare,[82] and commentators generally consider them less preferable than other measures.[83]

Finally, a more practical mechanism for shareholders to nominate directors or influence corporate governance is through a proxy access bylaw governed, in part, by Rule 14a-8.[84] A proxy access bylaw allows a shareholder to keep her shares and removes the cost barrier of a proxy contest.[85] Not surprisingly, this is the preferred method to effectuate shareholders' voting rights.[86] Additionally, a bylaw proposal, lacking the aforementioned cost barrier, allows a much broader spectrum of shareholders to participate in shaping corporate affairs.[87] Under proxy Rule 14a-8, a shareholder may submit a bylaw amendment proposal to the board for inclusion in the proxy statement.[88] Assuming the shareholder meets certain specified conditions, the board is required to include the bylaw proposal in the corporation's annual proxy statement.[89] Rule 14a-8(i) further delineates thirteen instances in which a bylaw proposal's substantive nature may violate the Rule.[90]

Of particular note, Rule 14a-8(i)(8) permits a company to exclude a bylaw proposal if it "relates to a nomination or an

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80. *See* Bebchuk, *supra* note 76, at 688.

81. *See id.* at 688–89 (citing the proxy contest at Six Flags in 2006, in which the insurgent spent roughly $850,000 on preparing and mailing proxy statements and associated legal fees); *Battling for Corporate America*, ECONOMIST, Mar. 11, 2006, at 70 (discussing the costs associated with engaging in a proxy contest).

82. *See* Bebchuk, *supra* note 16, at 856 (citing a study the author conducted in which he found, between 1996 and 2002, an average of only eleven proxy contests a year among the thousands of public companies).

83. *See, e.g.*, William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1403 (2007).

84. *See* 17 C.F.R. § 240.14a-8 (2010).

85. Fairfax, *supra* note 61, at 1267–68.

86. *Id.* at 1267.

87. *See id.* at 1267–68.

88. 17 C.F.R. § 240.14a-8.

89. *See* McDonnell, *supra* note 32, at 211.

90. *See* 17 C.F.R. § 240.14a-8(i)(1)–(13).

election for membership on the company's board of directors."[91] Facially, it appears the Rule effectively nullifies shareholders' efforts to approve a bylaw proposal seeking access to the corporation's proxy statement to nominate directors.[92] The SEC has largely adopted this view, and generally has permitted corporations to exclude proxy access bylaws that seek to enlarge shareholders' nominating powers.[93] Though the SEC for a brief period intimated that it would allow such proposals,[94] it quickly reversed course and reiterated its opposition to them.[95] As such, proxy access bylaws seeking to allow shareholders the power to nominate directors were seemingly a dead issue.[96]

The Second Circuit reinvigorated the shareholder nomination debate in *American Federation of State, County & Municipal Employees* (*AFSCME*) *v. American International Group, Inc.* (*AIG*).[97] In that case, AFSCME, one of the largest public-service-employee unions in the United States, submitted to AIG for inclusion in its proxy statement a shareholder proposal that would alter AIG's bylaws to require shareholder-nominated candidates to be on the company's proxy ballot.[98] AIG sought the approval of the SEC to exclude the proposal from its proxy statement under Rule 14a-8(i)(8) on the basis that it "relates to an election."[99] The SEC responded with a no-action letter supporting exclusion by AIG.[100] AIG summarily excluded the pro-

91. 17 C.F.R. § 240.14a-8(i)(8).

92. *See* Jay Razzouk, *The Momentum, Motive, and Mouse-Kapades of the Majority Vote Movement*, 1 J. BUS. ENTREPRENEURSHIP & L. 391, 415 (2008) ("Given this vague language, it would seem that a board could exclude any shareholder proposal dealing with director elections . . . .").

93. *See* McDonnell, *supra* note 32, at 211.

94. *See, e.g.*, The Walt Disney Co., SEC No-Action Letter, 2004 WL 2848301, at *1 (Dec. 8, 2004). For a discussion of the Walt Disney No-Action Letter, see McDonnell, *supra* note 32, at 212.

95. McDonnell, *supra* note 32, at 212; *see also* Fairfax, *supra* note 42, at 74 (discussing the SEC's "return to the status quo" by strictly limiting shareholders' access to the corporate ballot).

96. *See* J. Robert Brown, Jr., *The SEC, Corporate Governance and Shareholder Access to the Board Room*, 2008 UTAH L. REV. 1339, 1365 (commenting that before 2006 "[t]he proposal for shareholder access remained officially outstanding but effectively dead").

97. 462 F.3d 121 (2d Cir. 2006); *see also* Fairfax, *supra* note 42, at 74–75 (noting that *AFSCME* "breathed new life" into the issue of shareholders' power to nominate directors).

98. *AFSCME*, 462 F.3d at 123–24.

99. AIG, SEC No-Action Letter, 2005 WL 372266, at *4 (Feb. 14, 2005).

100. *Id.* at *1.

posal from its proxy statement; in response, AFSCME filed suit in federal court.[101]

The Second Circuit, hearing the case on appeal from the Southern District of New York,[102] reversed the lower court and mandated inclusion of the proxy-access bylaw.[103] In so holding, the court emphasized the publication of two informal, conflicting interpretations of Rule 14a-8(i)(8) by the SEC.[104] The first, published in 1976, contended that "a proposal may be excluded pursuant to Rule 14a-8(i)(8) if it *would* result in an immediate election contest."[105] The second, set forth in the SEC's amicus brief to the Second Circuit, argued that a company may exclude a proposal under Rule 14a-8(i)(8) if it *might* result in a contested election.[106] Acknowledging the conflict, the court rejected the SEC's more recent statement on the grounds that such conflicting interpretations result in less judicial deference to the rulemaking authority[107] and that the SEC failed to offer a reasoned analysis or even an explanation for its change in interpretation.[108] In affirming that the SEC's 1976 statement was the correct one, the court held that a company may only exclude a proposal under Rule 14a-8(i)(8) if it results in an immediate election contest.[109] In drawing this conclusion, the court distinguished between a shareholder proposal that would result in an immediate election contest and a proposal that "simply establish[es] a process for shareholders to wage a future election contest."[110]

The SEC's response to the Second Circuit's ruling has only led to further confusion.[111] Soon after *AFSCME*, the SEC announced that it would revise Rule 14a-8 to "assure its consist-

101. *AFSCME*, 462 F.3d at 124.

102. AFSCME v. AIG, 361 F. Supp. 2d 344 (S.D.N.Y. 2005), *rev'd*, 462 F.3d 121 (2d Cir. 2006).

103. *AFSCME*, 462 F.3d at 129–30.

104. *Id.* at 126.

105. *Id.* at 127 (emphasis added) (internal quotation marks omitted); *see also* Proposals by Security Holders, 41 Fed. Reg. 29,982, 29,985 (proposed July 20, 1976).

106. *AFSCME*, 462 F.3d at 126.

107. *Id.* at 129 ("[T]he SEC . . . has a 'duty to explain its departure from prior norms.'" (quoting Atchison, Topeka & Santa Fe Ry. Co. v. Wichita Bd. of Trade, 412 U.S. 800, 808 (1973))).

108. *Id.*; *see also* Fairfax, *supra* note 61, at 1276.

109. *AFSCME*, 462 F.3d at 127.

110. *Id.* at 128.

111. *See* Fairfax, *supra* note 42, at 75.

ent nationwide application."[112] Nonetheless, when another case presented an issue nearly identical to the issue in *AFSCME*, the SEC expressed no preference about whether the company may exclude the shareholder nomination proposal.[113] Six months later, the SEC spoke on the issue of proxy access, but with two conflicting proposals.[114] The first established a procedure enabling shareholders to include in company proxy materials "proposals for bylaw amendments regarding the procedures for nominating candidates to the board of directors."[115] The second provided that "shareholder proposals that could result in an election contest may be excluded under Rule 14a-8(i)(8)."[116] In 2007, the SEC adopted the latter proposal.[117]

C. RULE 14A-11 AND THE ADMINISTRATIVE PROCEDURE ACT

In light of the ensuing confusion, the SEC responded with Rule 14a-11, which effectively gives, with certain conditions, shareholders access to a company's proxy materials to nominate their own directors. The Rule has two working parts. First, it would amend Rule 14a-8(i)(8) to preclude companies from relying on that rule to exclude shareholder proposals seeking to amend a company's governing documents regarding director nomination procedures.[118] Second, the Rule requires companies, under certain circumstances, to "provide shareholders with information about, and the ability to vote for, a shareholder's . . . nominees for director in the companies' proxy materials."[119] The most notable condition is that a shareholder seeking to invoke Rule 14a-11 must "not hold the securities with the purpose, or with the effect, of changing the control of

112. 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.

113. *See* Hewlett-Packard Co., SEC No-Action Letter, 2007 WL 224970, at *1 (Jan. 22, 2007).

114. Shareholder Proposals, 72 Fed. Reg. 43,466 (proposed Aug. 3, 2007); Shareholder Proposals Relating to the Election of Directors, 72 Fed. Reg. 43,488 (proposed Aug. 3, 2007); *see also* Fairfax, *supra* note 42, at 77–78 (discussing the two conflicting proposals).

115. Shareholder Proposals, 72 Fed. Reg. at 43,466.

116. Shareholder Proposals Relating to the Election of Directors, 72 Fed. Reg. at 43,491.

117. Shareholder Proposals Relating to the Election of Directors, 72 Fed. Reg. 70,450 (Dec. 11, 2007) (codified at 17 C.F.R. § 240.14a-8).

118. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,677 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

119. *Id.*

the company or gaining more than a limited number of seats on the board."[120] Thus, the Rule does not permit a shareholder or group of shareholders to take over the board, but simply provides shareholders with a more meaningful tool to influence their corporations' governing structures.

One of the Rule's more controversial provisions is that shareholders cannot enact more stringent standards for access to a company's proxy materials, but only standards that are more lenient.[121] Commentators have argued that the Rule, for this reason alone, is invalid under the APA's arbitrary and capricious standard.[122]

Section 706(2)(A) of title 5 of the U.S. Code mandates courts to "hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary [and] capricious."[123] Often referred to as "hard look" review,[124] this standard, and the congressional intent behind it, has always generated debate.[125] As such, the courts' application of such review has changed considerably over time.[126]

Nonetheless, the Supreme Court in 2009 iterated its commitment to a deferential standard of review consistent with its earlier precedent.[127] Under this standard, an agency must only acknowledge the change in its policy,[128] "'examine the relevant data[,] and articulate a satisfactory explanation for its ac-

120. *Id.* at 56,699.

121. *Id.* at 56,680.

122. *See* Grundfest, *Internal Contradictions*, *supra* note 24, at 2 (arguing that the contradictions in Rule 14a-11 are "sufficiently material" that the Rule would be unlikely to withstand scrutiny under the APA).

123. 5 U.S.C. § 706(2)(A) (2006).

124. *See, e.g.*, Thomas J. Miles & Cass R. Sunstein, *The Real World of Arbitrariness Review*, 75 U. CHI. L. REV. 761, 761 (2008) ("The doctrine . . . require[s] administrative agencies to demonstrate that they [have] taken a 'hard look' at the underlying questions of policy and fact.").

125. *See* MARTIN SHAPIRO, WHO GUARDS THE GUARDIANS? JUDICIAL CONTROL OF ADMINISTRATION 56 (1988) ("There has always been some debate about what th[e] words [arbitrary and capricious] mean.").

126. *See* Kathryn A. Watts, *Proposing a Place for Politics in Arbitrary and Capricious Review*, 119 YALE L.J. 2, 15 (2009). *Compare* Nat'l Broad. Co. v. United States, 319 U.S. 190, 215–19 (1943) (taking a very deferential stance towards administrative rulemaking), *with* Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 48–49 (1983) (requiring a heightened review of an administrative regulation).

127. FCC v. Fox Television Stations, Inc., 129 S. Ct. 1800, 1810 (2009).

128. *Id.* at 1811 ("To be sure, the requirement that an agency provide reasoned explanation for its action would ordinarily demand that it display awareness that it *is* changing position.").

tion.'"[129] In other words, the agency must explicate "good reasons" for the new policy[130] by establishing a "rational connection between the facts found and the choice made."[131] Described as a sort of "lunacy test," a court should only reject an agency rule "if no reasonable person could have written [it]."[132] In applying the test, a court may not substitute its own judgment for that of the agency and should uphold agency action, even one that is not of ideal clarity, as long as the court can reasonably discern the agency's reasoning.[133]

In light of the foregoing discussion, Part II evaluates Rule 14a-11 in the context of the reality of modern corporations and the Rule's ability to withstand judicial scrutiny under the APA.

II. THE CASE FOR INCREASING SHAREHOLDER RIGHTS AND THE VALIDITY OF RULE 14A-11 UNDER THE ARBITRARY AND CAPRICIOUS STANDARD

Because Rule 14a-11 departs from the SEC's previous understanding of proxy access, detractors will likely challenge the Rule on the basis that it is arbitrary and capricious under the APA.[134] This Part discusses and analyzes two distinct aspects of the issue. The first section addresses the question of whether enlarged shareholder rights are a legitimate goal as a matter of necessity and prudence. The second analyzes three aspects of Rule 14a-11 under the common-law understanding of arbitrary and capricious review.

129. *Id.* at 1810 (quoting *State Farm*, 463 U.S. at 43).

130. *Id.* at 1811.

131. *State Farm*, 463 U.S. at 43 (quoting Burlington Truck Lines v. United States, 371 U.S. 156, 168 (1962)).

132. SHAPIRO, *supra* note 125, at 56.

133. *See State Farm*, 463 U.S. at 43 (quoting Bowman Transp., Inc. v. Ark.-Best Freight Sys., Inc., 419 U.S. 281, 286 (1974)).

134. These complaints have already begun. *See* Petition for Review at 2, Bus. Roundtable v. U.S. SEC, No. 10-1305 (D.C. Cir. Sept. 29, 2010); *see also* Brief in Support of Motion for Stay of Proxy Access Rules by Business Roundtable and Chamber of Commerce of the United States of America at 2–8, Bus. Roundtable v. U.S. SEC, No. 10-1305 (D.C. Cir. Sept. 29, 2010). Soon after the Business Roundtable and the Chamber of Commerce filed their Petition for Review, the SEC issued an Order Granting Stay, effectively staying enforcement of Rule 14a-11 and the amendment to Rule 14a-8 pending resolution of the Petition for Review by the D.C. Circuit. Order Granting Stay, In the Matter of the Motion of Business Roundtable and the Chamber of Commerce of the United States of America, for Stay of Effect of Commission's Facilitating Shareholder Director Nomination Rules, File No. S7-10-09, *available at* http://www.sec.gov/rules/other/2010/33-9149.pdf.

A. THE CASE FOR INCREASING SHAREHOLDER RIGHTS

Although Berle and Means successfully documented and predicted the new economic realities associated with the division between ownership and control of corporations,[135] they failed to speak about whether shareholders in this new era should have the requisite control to influence substantive issues of corporate governance. More specifically, they neglected to address whether the law should allow a shareholder—in some instances, just one of hundreds of thousands of shareholders—to vote on the minutiae of corporate governance matters.

A number of corporate law scholars and commentators have alleged that greater shareholder power to nominate directors will have deleterious effects on America's corporations.[136] Two such arguments are of particular note. First, some scholars contend that boards of directors exhibit a greater capacity than shareholders to run a corporation in an efficient and profitable manner.[137] Second, other commentators maintain that greater shareholder power will work to benefit only large special-interest shareholders, such as public pension funds, who will use such power in a way that is not beneficial to shareholders in the aggregate.[138] Both arguments, though highlighting possible imperfections in shareholders' power to nominate directors, do not override the inherent benefits associated with greater shareholder influence in this area.

First, a number of commentators have expressed the concern that shareholders' ability to nominate directors could impede the proper functioning of a board and consequently cause

135. *See* BERLE & MEANS, *supra* note 33, at 119–25; *id.* at 352 ("Most fundamental to the new picture of economic life must be a new concept of business enterprise concentrated in the corporate organization.").

136. *See, e.g.*, Paul Atkins, Op-Ed., *The SEC's Sop to Unions*, WALL ST. J., Aug. 27, 2010, at A15 ("[Rule 14a-11] will give [unions and cause-driven, minority shareholders] pressure points with which to hold companies hostage until their pet issues are addressed."); Thomas J. Donohue, *SEC Proxy Plan Is a Threat to Business, Boon to Labor*, INVESTOR'S BUS. DAILY, Dec. 4, 2003, at A14 ("The Securities and Exchange Commission['s] . . . unfortunate [Rule 14a-11] proposal . . . could seriously impair the competitiveness of America's best companies . . . and needlessly complicate corporate governance issues . . . .").

137. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 81–89 (1991).

138. *See, e.g.*, Christopher J. Smart, *Takeover Dangers and Non-Shareholders: Who Should Be Our Brothers' Keeper?*, 1988 COLUM. BUS. L. REV. 301, 317 (discussing the threat of institutional investors' use of power in a way that is unacceptable to the general public).

inefficiencies in corporate decisionmaking.[139] Henry G. Manne, the first legal commentator to analyze the corporate form from an economic perspective,[140] argued that the corporate form effectively assumes a centralized form of management in the board of directors.[141] For that reason, limits as to what shareholders could vote on were wholly consistent with the economic function of corporations.[142] Others have gone further and argued that investor involvement in corporate decisionmaking would likely upset the "hierarchical decisionmaking structure" that is well suited to the corporate form, and would consequently lead to inefficient management.[143] Furthermore, critics charge that a firm, to appease certain constituencies, may adopt a more moral or socially desirable strategy in lieu of one that maximizes profit through more efficient decisionmaking by a board.[144]

Other scholarly criticism has focused on shareholders' competency and their general apathy towards corporate affairs.[145] A number of critics, even some proponents, have expressed concerns about shareholders' competency.[146] One such concern is that the vast number of shareholders, even large institutional investors, hold such highly diversified portfolios that it would be illogical for them to focus on any one particular corporation.[147] The above views, however, fail to consider the significant gains in corporate governance shareholders have

139. *E.g.*, Letter from David T. Hirschmann, Senior Vice President, Chamber of Commerce of the United States, to Nancy M. Morris, Sec'y, SEC 10 (Oct. 2, 2007), *available at* http://sec.gov/comments/s7-16-07/s71607-482.pdf.

140. Peter V. Letsou, *Shareholder Voice and the Market for Corporate Control*, 70 WASH. U. L.Q. 755, 774 (1992).

141. Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 260–61 (1967) ("The first important legal norm which can be derived from the central concept of the corporation as a capital-raising device is that of centralized management . . . .").

142. Letsou, *supra* note 140, at 774.

143. Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1749 (2006).

144. EASTERBROOK & FISCHEL, *supra* note 137, at 85 ("[T]he proposal [to increase shareholder influence], because of the publicity generated or otherwise, causes the firm to abandon a profit-maximizing strategy in favor of one that some find more 'moral' or 'socially responsible.'").

145. *See, e.g.*, MACEY, *supra* note 7, at 199; Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1274–75 (1982) ("[M]ost shareholders have little interest in running the corporation's affairs.").

146. *See* Fairfax, *supra* note 61, at 1269–70; Fischel, *supra* note 145, at 1274–75.

147. *See* MACEY, *supra* note 7, at 199.

achieved in light of the recent corporate scandals and financial crisis.

Patrick McGurn, senior vice president and special counsel at Institutional Shareholder Services, stated that "poor governance is a substantial risk factor" for shareholders.[148] After Enron and the more recent financial crisis, shareholders have recognized this risk and have demonstrated a greater desire to engage in corporate governance decisions.[149] For instance, in 2007, forty-three percent of Hewlett Packard's shareholders voted in favor of a proxy access proposal.[150] Some commentators argued that such a percentage, which was insufficient to approve the proposal, does not support the proposition that shareholders are now more willing to engage in corporate governance issues.[151] But these critics fail to acknowledge that forty-three percent represents a significant achievement for a shareholder proposal. In the past, commentators considered a shareholder proposal successful if it garnered as little as five percent of the vote.[152] Moreover, recent data show shareholders are voting in higher numbers, differentiating among the issues presented to them, and organizing as a collective body at a much greater rate.[153] Thus, the reforms presented in Rule 14a-11 would arguably serve only to increase these gains, thereby generating even greater involvement by shareholders in corporate governance issues.

Second, some critics have maintained that greater proxy access may prove ineffective as a means to empower shareholders generally.[154] Instead, these critics argue that greater proxy access will entrench power in large institutional investors that

148. Burns, *supra* note 29, at R6.

149. *See* Rose A. Zukin, Comment, *We Talk, You Listen: Should Shareholders' Voices Be Heard or Stifled When Nominating Directors? How the Proposed Shareholder Director Nomination Rule Will Contribute to Restoring Proper Corporate Governance*, 33 PEPP. L. REV. 937, 940 (2006) (noting shareholders' demands for a greater role in corporate governance).

150. H. Bryan Brewer, *Proxy Season 2007: More Smoke than Fire*, FIN. EXECUTIVE, July 1, 2007, at 18, *available at* 2007 WLNR 26769230.

151. *See* Bainbridge, *supra* note 143, at 1751 ("[I]t is improbable that dispersed individual investors with small holdings will ever be anything other than rationally apathetic . . . .").

152. EASTERBROOK & FISCHEL, *supra* note 137, at 83.

153. *See* Barnard, *supra* note 68, at 80.

154. *See, e.g.*, Roberta S. Karmel, *Implications of the Stakeholder Model*, 61 GEO. WASH. L. REV. 1156, 1157–68 (1993) (discussing the divergent behavior, interests, and regulation of institutional investors).

will advance their own narrow and selfish interests.[155] For instance, proposals that are beneficial to labor unions, such as rights desired by union fund managers, may not be, and often will not be, for the benefit or even in the best interest of shareholders generally.[156]

This argument is problematic for at least two reasons. First, nothing suggests that the interests of institutional investors inevitably run counter to those of shareholders.[157] For instance, on at least two occasions AFSCME sought to include proposals that served the interests of all shareholders.[158] Second, evidence suggests that institutional investors have been, and continue to be, largely inactive and ineffective as corporate monitors.[159] Though in the early 1990s institutional investors played a more active role in corporate governance than they had previously, their effect on governance leading into the new century remained negligible.[160] Furthermore, evidence also suggests that these efforts had meager effects on

155. *See, e.g.*, Bainbridge, *supra* note 143, at 1751 (contending that large institutional investors are the shareholders most likely to misuse their powers for private gains); Atkins, *supra* note 136, at A15 ("[U]nions and cause-driven, minority shareholders . . . would use [Rule 14a-11] to advance their own labor, social and environmental agendas instead of the corporation's goal of maximizing long-term shareholder wealth."); Troy A. Paredes, Comm'r, SEC, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), *available at* http://www.sec.gov/news/speech/2009/spch052009tap.htm ("[W]e need to be mindful that proxy access might privilege certain shareholders at the expense of others.").

156. *See* Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 231 (2001) (discussing institutional investors' and shareholders' sometimes divergent priorities).

157. *See* Fairfax, *supra* note 61, at 1271–72.

158. *See* AFSCME v. AIG, 462 F.3d 121, 131 (2d Cir. 2006) (ruling in favor of an AFSCME bylaw proposal that required the corporation to include shareholder-nominated candidates for election to the board); CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 240 (Del. 2008) (ruling against an AFSCME bylaw amendment that required reimbursement of shareholder expenses incurred in nominating candidates for election to the board).

159. *See* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 203–09 (2008) (discussing the passivity of institutional shareholders and the reasons behind it).

160. *See* Bainbridge, *supra* note 16, at 629 (noting institutional investors' somewhat surprising lack of activity as investor activists); Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459, 460 (Peter Newman ed., 1998) ("Even the most activist institutions spend less than half a basis point of assets under management (0.005%) per year on their governance efforts.").

firm performance and practices.[161] Thus, as presumably rational actors seeking to maximize profits, many institutional investors would be ill-served by expending costs in excess of such fleeting benefits.[162] Accordingly, despite anecdotal evidence to the contrary,[163] it does not appear that greater shareholder access to proxy statements would result in significant abuse by large institutional investors.

Beyond the arguments against greater shareholder access, increased shareholder power can serve as a boon to corporations. For instance, a board consisting of homogeneous, constituent directors is more apt to exhibit "groupthink" tendencies.[164] In this situation, boards will often abandon alternative courses of action in an effort to instill cohesiveness and attain unanimity in board decisions.[165] Rule 14a-11 works to put in place directors who are independent from the board's constituents and who, therefore, can provide different points of view.[166] Although shareholder-nominated directors will not eliminate groupthink, the risk is reduced because such directors are not beholden to the CEO or other corporate officers.[167]

161. Black, *supra* note 160, at 459.

162. Bainbridge, *supra* note 143, at 1752 ("Most institutional investors are profit maximizers, who will not engage in activities whose costs exceed their benefits.").

163. *See, e.g.*, Stephen M. Bainbridge, *A Comment on the SEC Shareholder Access Proposal* 12–13 (Univ. of Cal., L.A. Sch. of Law, Law & Econ. Research Paper No. 03-22, 2003), *available at* http://ssrn.com/abstract=470121 ("If the board becomes more beholden to the interests of large shareholders, it may become less concerned with the welfare of smaller investors.").

164. Barnard, *supra* note 68, at 76 (remarking on the higher tendency of "groupthink" in homogeneous boards); *see also* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 91–99 (1985) (analyzing the homogeneity of corporate board make up and concluding that "powerful psychological factors are at work within the boardroom, creating a cohesive, loyal, conforming ingroup that will support its members for positive and negative reasons").

165. *See* Barnard, *supra* note 68, at 76 ("'Groupthink' is . . . when the members' striving for unanimity override their motivation to realistically appraise alternative courses of action.").

166. *Cf.* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 63 (2003) (supporting the then-proposed SEC Rule 14a-11 because of the effect "independent directors" would have on corporate performance).

167. *See* LORSCH & MACIVER, *supra* note 8, at 17 ("[M]any directors . . . feel they are serving at the pleasure of the CEO-chairman.").

Additionally, because the business judgment rule insulates directors from judicial review,[168] shareholders should act as a check on boards of directors.[169] Recognizing this, some courts argue that any redress for board failures must come from the power of "corporate democracy"—the notion that shareholders, if displeased with board action, can simply vote the board out.[170] However, this power is primarily formalistic and has little real impact on corporate policymaking.[171] In reality, the current proxy process divests shareholders' voting rights of any real weight.[172] Because the boards, with little or no shareholder input, select the candidates listed in the proxy materials, corporate elections are, effectually, a "rubber stamp" on the boards' choice.[173] The outcome is predetermined and rarely in question.[174] Based on this system, board members are almost guaranteed reelection, limiting any damages directors may suffer for failing to act in the shareholders' best interests.[175] The reforms contained in Rule 14a-11 will therefore provide teeth to the rights shareholders already have, increasing board accountability and improving corporate governance.

B. THE VALIDITY OF RULE 14A-11 UNDER THE APA'S ARBITRARY AND CAPRICIOUS STANDARD

Because critics will challenge Rule 14a-11 as arbitrary and capricious,[176] this section examines three aspects of that argu-

168. *See supra* notes 46–49 and accompanying text.

169. *See* Bebchuk, *supra* note 76, at 680.

170. 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."); *see also In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005) ("The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not this Court."), *aff'd*, 906 A.2d 27 (Del. 2006).

171. *See* Joo, *supra* note 9, at 673 (discussing the meager impact shareholder voting actually has on corporate decisionmaking).

172. Rodrigues, *supra* note 50, at 261–62.

173. Fairfax, *supra* note 61, at 1266.

174. *See id.*

175. *Id.* at 1267 ("[D]irectors are virtually guaranteed reelection, decreasing their need to be concerned with repercussions for their failure to act in a manner that benefits shareholders.").

176. *See, e.g.*, Grundfest, *Proposed Proxy Access Rules*, *supra* note 24, at 373–75 (arguing that Rule 14a-11 is arbitrary and capricious); Jessica Holz & Dennis Berman, *Investors Gain New Clout*, WALL ST. J., Aug. 26, 2010, at A1 (discussing Commissioner Casey's criticism: "the SEC fell short in its due diligence to show the benefits of proxy access outweigh its costs"); Jesse

ment and analyzes each based on the Supreme Court's most recent understanding of the arbitrary and capricious standard. The first, based on judicial precedent, mandates that the SEC, in its release of Rule 14a-11, provide a reasoned basis for the Rule.[177] Such reasoning must be grounded in "technocratic, statutory, or scientifically driven terms."[178] The second and third aspects of the argument represent alleged contradictions that are each sufficient to invalidate the Rule under the arbitrary and capricious standard. In particular, at least one commentator has alleged that the SEC's efforts to replicate more accurately physical shareholders' meetings[179] and its alleged stance in the Rule that shareholders are selectively intelligent[180] are inherently contradictory and thus invalid under the APA.[181]

1. Rule 14a-11 and the Lunacy Test

The Supreme Court has held that to avoid invalidation under arbitrary and capricious review, an agency must satisfy two elements. First, the agency must provide relevant data and a satisfactory explanation of its purposes for formulating the rule.[182] Second, sometimes referred to as the "lunacy test,"[183] an agency must show that there is a "rational connection between the facts found and the choice made."[184] In considering this element, a court will strike down an agency rule "only if no reasonable person could have written such a rule."[185] In applying

Westbrook, *The SEC's Plan to Pry Open Corporate Boards*, BLOOMBERG BUS. WK., Aug. 16–29, 2010, at 29, 30 (commenting on the legal challenges that lie ahead for Rule 14a-11); Kathleen L. Casey, Comm'r, SEC, Statement at Open Meeting to Adopt Amendments Regarding Facilitating Shareholder Director Nominations (Aug. 25, 2010), *available at* http://www.sec.gov/news/speech/2010/spch082510klc.htm ("I believe that the rule is so fundamentally and fatally flawed that it will have great difficulty surviving judicial scrutiny.").

177. FCC v. Fox Television Stations, Inc., 129 S. Ct. 1800, 1804 (2009) ("It suffices that the new policy is permissible under the statute, that there are good reasons for it, and that the agency *believes* it to be better . . . .").

178. Watts, *supra* note 126, at 5.

179. Grundfest, *Internal Contradictions*, *supra* note 24, at 2–3.

180. *Id.* at 2.

181. *Id.*

182. *Fox Television*, 129 S. Ct. at 1810 (citing Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983)).

183. *See* SHAPIRO, *supra* note 125, at 56.

184. *State Farm*, 463 U.S. at 43 (quoting Burlington Truck Lines v. United States, 371 U.S. 156, 168 (1962)).

185. SHAPIRO, *supra* note 125, at 56.

this standard, a court will not substitute its judgment for the judgment of the agency.[186]

First, the SEC, in its proposed release of Rule 14a-11, argued that the need for reform to the federal proxy rules has become more apparent in the wake of "one of the most serious economic crises of the past century."[187] The financial crisis raised significant concerns about whether boards are adequately monitoring corporate officers.[188] In addressing such concerns, the SEC noted the inadequacy of shareholders' existing options to implement change.[189] Rule 14a-11, the SEC argued, would help resolve this dilemma by providing shareholders with "a more plausible avenue . . . to participate in the governance of their company."[190]

In addition, the SEC offered a significant statistical analysis to support adoption of Rule 14a-11.[191] The SEC's analysis emphasized three points. First, the SEC found that boards in which shareholders were able to nominate and elect dissident directors, but not take control of the board, improved shareholder value by 19.1 percent.[192] Second, it noted that a shareholder-nominated director on the board increases transparency and thus lowers costs associated with capital and trading of the firm's securities.[193] Finally, the SEC emphasized that Rule 14a-11 would lower the direct and indirect costs activist shareholders would incur in engaging in a proxy contest.[194] According to

186. *Fox Television*, 129 S. Ct. at 1810.

187. Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024, 29,025 (proposed June 18, 2009).

188. *See* Rodrigues, *supra* note 50, at 255 ("Too often boards of directors have proved to be passive spectators, either unwilling or unable to monitor the actions of management.").

189. *See* Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29,027–28 (discussing proxy contests, bylaw proposals under Rule 14a-8, and the "Wall Street Walk").

190. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,761 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

191. *See generally* Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29,071–77 (describing the cost-benefit analysis conducted by the SEC).

192. *Id.* at 29,074 n.349 (citing CHRIS CERNICH ET AL., EFFECTIVENESS OF HYBRID BOARDS 3 (2009), *available at* http://www.irrcinstitute.org/pdf/IRRC_05_09_EffectiveHybridBoards.pdf).

193. *Id.* at 29,074. This proposition was supported in a recent study. *See* Christian Leuz & Robert E. Verrecchia, *The Economic Consequences of Increased Disclosure*, 38 J. ACCT. RES. 91, 120–21 (Supp. 2000) (finding, in part, that firms with greater levels of disclosure statistically and economically garnered greater benefits than firms that did not).

194. Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29,073.

a previous study cited by the SEC, a shareholder invoking Rule 14a-11 would save at least $18,000 by not having to pay for the printing and postage needed to wage a proxy contest.[195] Thus, the SEC, in response to the concerns of inadequate board performance, sufficiently explained itself and justified its explanation with relevant data.

The second prong of the Court's arbitrary and capricious test requires the SEC to establish a rational connection between the facts relied upon and its choice of Rule 14a-11 as an answer.[196] According to the Court, a court would normally regard an agency ruling as arbitrary and capricious if the agency relied on factors outside the purview that Congress set for it, entirely failed to consider an important facet of the problem, offered an explanation that ran counter to its evidence, or if its explanation was wholly implausible.[197]

Based on the above guidance, the SEC established a sufficiently rational connection to pass judicial scrutiny under the arbitrary and capricious standard. Congress has long understood the SEC's role under the Exchange Act to make "intelligent adjustments"[198] in corporate law that serve to regulate "individuals [who] wield the power of thousands."[199] In reaffirming the SEC's mandate, Congress recently provided the SEC with the authority to promulgate rules to facilitate shareholders' access to corporations' proxy materials.[200] Accordingly, Rule 14a-11, the manifestation of Congress's will in the Dodd-Frank Act, is within the purview of the SEC's power as established by Congress.[201]

Whether the Rule fails to "consider an important aspect of the problem" presents a dilemma.[202] What, exactly, constitutes an important problem? An agency rule may rise or fall based on which answer to this question—if there is one at all—a plaintiff

195. *Id.*

196. Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983).

197. *Id.*

198. H.R. REP. NO. 73-1383, at 3 (1934) (discussing the need for an agency to make adjustments in corporate law pursuant to ever-changing times).

199. *Id.* at 5 (alluding to boards of directors who oversee corporations owned by thousands of shareholders).

200. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010).

201. *See supra* notes 53–64 and accompanying text.

202. *State Farm*, 463 U.S. at 43.

or a judge can conjure in court.[203] The case *Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co.*,[204] however, provides some guidance. In that case, the Court ruled that the agency's rescission of crash protection requirements under federal law was arbitrary and capricious.[205] The Court ruled that the agency's failure to consider an equally effective alternative to the current system in lieu of rescission was sufficient to render it invalid under the APA.[206] Though an agency rule "cannot be found wanting simply because the agency failed to include every alternative device and thought conceivable by the mind of man,"[207] an agency must consider all viable and material alternatives related to the existing standard.[208]

Rule 14a-11 satisfies this standard. In its June 2009 proposed rule, the SEC discussed the existing shareholder options both within and without the federal proxy system.[209] The SEC emphasized that shareholder options within the system—bylaw proposals under Rule 14a-8(i)(8) and withhold-vote campaigns—were insufficient to provide shareholders any real say over the nomination process.[210] Concerning the former, the SEC stated that Rule 14a-8(i)(8) is ineffective because it precludes bylaw proposals that relate to director elections.[211] The SEC similarly found that withhold-vote campaigns are equally ineffective because of many corporations' adoption of a plurali-

203. *See* Scott A. Keller, *Depoliticizing Judicial Review of Agency Rulemaking*, 84 WASH. L. REV. 419, 468 (2009).

204. 463 U.S. 29.

205. *Id.* at 57.

206. *Id.* at 56 ("By failing to analyze the continuous seatbelts option in its own right, the agency has failed to offer the rational connection between facts and judgment . . . .").

207. Vt. Yankee Nuclear Power Corp. v. Natural Res. Def. Council, Inc., 435 U.S. 519, 551 (1978) (holding that the Atomic Energy Commission's consideration of licensing nuclear reactors was not arbitrary and capricious under the APA).

208. *State Farm*, 463 U.S. at 51 ("But the airbag is more than a policy alternative to the passive restraint Standard; it is a technological alternative within the ambit of the existing Standard.").

209. Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024, 29,027–28 (proposed June 18, 2009).

210. *Id.* at 29,028.

211. *Id.* (discussing the criticisms of Rule 14a-8(i)(8) as a practical tool for shareholder participation in the nomination of directors).

ty-voting system.[212] In plurality voting, a candidate can win a seat on the board "regardless of whether [she] receive[s] more than 50% of the shareholder vote."[213] A candidate, therefore, can theoretically be elected to a corporation's board with a single vote.[214] Accordingly, withhold-vote campaigns, though expressing shareholders' discontent, do not offer shareholders a practical mechanism to affect board nomination processes.[215]

Similarly, the SEC considered and rejected as impractical options outside the federal proxy process.[216] The Wall Street rule, in particular, is not an optimal solution for shareholders, as the selling shareholder will receive no benefit from any possible improvement in management.[217] Moreover, submitting nominees directly to the board or nominating a director at a shareholder meeting, the SEC argued, are equally ineffective in securing shareholders' ability to nominate directors.[218]

Given Congress's grant of power and that the SEC has established a sufficiently rational connection between the facts found and its choice of remedy in Rule 14a-11, the Rule will likely withstand judicial scrutiny. Concerns still remain, however, about contradictions within the Rule that would allegedly render it arbitrary and capricious.

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212. *Id.* For a discussion of plurality voting and proxy access, see Vincent Falcone, *Majority Voting in Director Elections: A Simple, Direct, and Swift Solution?*, 2007 COLUM. BUS. L. REV. 844, 847–55.

213. Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29,028.

214. *See* Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1010 (2010) ("Under plurality voting, the directors who receive the most votes are elected. This means, in effect, that if the number of nominees is equal to the number of vacancies—as is the case in the overwhelming majority of director elections—every nominee is assured election since it takes only one vote to be elected.").

215. Outside of the SEC's analysis, the ineffectiveness of withhold-vote campaigns is well documented. *See, e.g.*, Annalisa Barrett & Beth Young, *Majority of Votes Withheld: Shareholders Say "No," Boards Say "Yes,"* 16 CORP. GOVERNANCE ADVISOR, July–Aug. 2008, at 6, 6.

216. *See* Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29,028.

217. *Id.*

218. *Id.* (referencing boards' general unwillingness to include shareholder nominated directors on the company's proxy statement and the futility, given the near universal use of proxy voting, of nominating a director at a shareholder meeting).

2. The SEC's Attempt to Better Replicate the Physical Shareholder Meeting

In Rule 14a-11, the SEC asserts that a function of the federal proxy rules is to establish a proxy system that as closely as possible acts as a replacement for the in-person shareholder meeting.[219] The SEC found that the two areas that create the greatest impediments to shareholders' rights are the director nomination and shareholder proposal processes.[220] Accordingly, the SEC sought in Rule 14a-11 to "refin[e] the proxy process so that it replicates, as nearly as possible, the annual meeting[,] . . . given that the proxy process has become the primary way for shareholders to learn about the matters to be decided by the shareholders and to make their views known to company management."[221] Rule 14a-11 serves to protect the rights of shareholders envisioned under state corporate law.[222]

However, one commentator has argued that the Rule utterly fails to replicate the annual meeting process.[223] According to this criticism, the Rule would impose a mandatory, one-size-fits-all form of proxy access that fails to emulate the current annual shareholder meeting or any features of state corporate law that govern these meetings.[224] Advocates of this view focus on the Rule's supplanting of state corporate law's bylaw access provisions in establishing a "minimum access" regime.[225] State law, unlike Rule 14a-11, "establishes no minimum standard for proxy access in terms of the percentage of shares held or the required holding period, and permits the imposition of any lawful condition on access."[226] This line of thought, unfortunately, misinterprets the SEC's purpose and reasoning. In doing so, it proposes using a machete when, at the very most, a scalpel would suffice.

In 1943, SEC Chairman Ganson Purcell told Congress that the SEC works to assure for shareholders "those rights that

219. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,670 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

220. Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29,026.

221. *Id.* at 29,025.

222. *Id.* ("In identifying the rights that the proxy process should protect, the Commission has sought to take as a touchstone the rights of shareholders under state corporate law.").

223. Grundfest, *Internal Contradictions*, *supra* note 24, at 7.

224. *Id.* at 7–8.

225. *E.g.*, *id.* at 8. For a more detailed discussion of the "Mandatory Minimum Access Regime," see notes 23–24 and accompanying text.

226. Grundfest, *Internal Contradictions*, *supra* note 24, at 8–9.

[they] ha[ve] traditionally had under State law to appear at the meeting; to make a proposal; to speak on that proposal at appropriate length; and to have his proposal voted on."[227] The dispersion of shareholders' interests throughout the country, Chairman Purcell continued, rendered these rights largely meaningless.[228] The former practice of a shareholder addressing her fellow shareholders at an annual meeting is at an end.[229] Today, a shareholder "can only address the assembled proxies which are lying at the head of the table."[230] Rule 14a-11 seeks to remedy this by providing a forum, beyond the largely ineffectual in-person meeting, in which shareholders can again make their voices heard and have their proposals voted on.

The proponents' of the alleged contradictions focus on the relation between bylaw access proposals and the SEC's "replicate" language disregards what the SEC is really attempting to do in the Rule.[231] In its June 2009 proposed rule, the SEC clarified that it seeks to fulfill those rights discussed by Chairman Purcell:[232] to make a proposal, to speak on that proposal, and to have the proposal voted on at the shareholders' meeting.[233] Thus, the SEC's effort in Rule 14a-11 to better replicate an actual in-person shareholder meeting does not result in a contradiction that would render it arbitrary and capricious. Instead, the Rule simply seeks to provide those rights shareholders have traditionally had under state law: to make a proposal, to speak on that proposal, and to have that proposal voted on.

227. *Security and Exchange Commission Proxy Rules: Hearing on H.R. 1493, H.R. 1821, and H.R. 2019 Before the H. Comm. on Interstate and Foreign Commerce*, 78th Cong. 172 (1943) (statement of Ganson Purcell, Chairman, SEC) [hereinafter Purcell Statement].

228. *Id.*; *see also* Rodrigues, *supra* note 50, at 264 ("Shareholders theoretically could nominate board candidates at a company's annual meeting. In almost all cases, however, voting will have already been accomplished by proxies distributed beforehand, so such a nomination would be little more than an empty gesture.").

229. Purcell Statement, *supra* note 227, at 174.

230. *Id.*

231. *See, e.g.*, Grundfest, *Internal Contradictions*, *supra* note 24, at 7–9.

232. Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024, 29,025 (proposed June 18, 2009).

233. Purcell Statement, *supra* note 227, at 172.

3. Rule 14a-11 and Shareholder Self-Determination

Rule 14a-11 sets a hard limit on the amount of access shareholders may have to a company's proxy statement.[234] The Rule only allows a corporate board or even a majority of shareholders to provide for greater access to a company's proxy statement, and expressly forbids rules allowing for less access.[235]

This alleged contradiction is predicated on the idea that if a basic premise of every proxy access proposal is the assumption that a majority of shareholders are "sufficiently intelligent and responsible that they can be relied upon to nominate and elect directors" of their own,[236] then, assuming that is true, the same shareholders should be "sufficiently intelligent and responsible to define the protocols governing when, how, and to whom access is granted."[237] Professor Joseph Grundfest, in a comment to the SEC, suggests that there can be no plausible argument to justify the contention that the SEC should treat shareholders as "selectively intelligent and responsible."[238] Moreover, he argues that the SEC in Rule 14a-11 provided no theoretical or empirical support for such an argument.[239] In effect, the SEC failed to definitively answer the question as to whether there is any rational support for the Rule.[240]

This alleged contradiction, however, is not sufficiently legally significant under the APA to render Rule 14a-11 arbitrary and capricious.[241] Plaintiffs have generally only argued that agency action is arbitrary and capricious based on an internal

234. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,673 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249) (disallowing a company and its shareholders to opt out or alter the application of Rule 14a-11); *see also* Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29,031 ("[S]tate law or a company's governing documents may provide for nomination or disclosure rights in addition to those provided pursuant to Rule 14a-11 . . . .").

235. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,680 ("[W]e are not persuaded that we should allow our rules to be altered by shareholders or boards to the potential detriment of other shareholders.").

236. Grundfest, *Internal Contradictions*, *supra* note 24, at 5.

237. *Id.*

238. *Id.* at 6.

239. *Id.*

240. *Id.*

241. *See* Nat'l Ass'n of Home Builders v. Defenders of Wildlife, 551 U.S. 664, 657 (2007) (overruling the Ninth Circuit's decision that the agency decision was arbitrary and capricious because it relied "on legally contradictory positions").

contradiction in four instances: when the agency (1) has committed a blatant contradiction between the evidence and the conclusion,[242] (2) does not include relevant scientific evidence that runs counter to its conclusion,[243] (3) has changed its mind throughout the rulemaking process,[244] and (4) has internal legal contradictions.[245] At issue here, it appears, is the fourth instance.

The argument that Rule 14a-11 restricts shareholder self-determination relies on the contention that there is no credible argument that shareholders are selectively intelligent and responsible.[246] However, the SEC's distinction appears to concern issues of policy and not of law. For instance, there is a credible argument that a corporation, as a shareholder in particular companies, will work for stricter access standards, in order to set a precedent for its own company. Any proxy access proposal, therefore, would be meaningless. Thus, the argument that the SEC is treating shareholders as selectively intelligent and responsible confuses the SEC's overarching policy argument with an arbitrary distinction.

Moreover, courts have consistently held that they will "uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned."[247] Irrespective of the alleged contradiction, the SEC makes evident in the Rule that it seeks to prevent frustration of shareholders' free exercise of their voting rights.[248] In light of the current law effectively rendering

242. *See, e.g.*, Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983) (holding as arbitrary and capricious an agency conclusion that runs counter to its evidence).

243. *See, e.g.*, Islander E. Pipeline Co. v. Conn. Dep't of Envtl. Prot., 467 F.3d 295, 313 (2d Cir. 2006) (ruling that an agency's failure to include contradictory studies renders the rule arbitrary and capricious).

244. *See, e.g.*, Nw. Coal. for Alts. to Pesticides v. U.S. EPA, 544 F.3d 1043, 1051 (9th Cir. 2008) (declaring that internally inconsistent determinations made during the decisionmaking process do not render the agency's final conclusions arbitrary and capricious).

245. *See, e.g.*, *Nat'l Ass'n of Home Builders*, 551 U.S. at 657–59 (holding that the agency's conclusions were not based on legally contradictory determinations).

246. *See* Grundfest, *Internal Contradictions*, *supra* note 24, at 5–6.

247. *State Farm*, 463 U.S. at 43 (quoting Bowman Transp., Inc. v. Ark.-Best Freight Syst., Inc., 419 U.S. 281, 286 (1974)).

248. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,684 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249) ("We continue to believe that parts of the proxy process may frustrate the exercise of shareholders' rights to nominate and elect directors arising under State law, and thereby fail to provide fair corporate suffrage.").

shareholders' voting rights meaningless,[249] the SEC copiously outlined its rationale for proposing Rule 14a-11.[250] Accordingly, a court should not hold Rule 14a-11 to be arbitrary and capricious under the APA.

The barriers to the exercise of shareholder power built into modern corporation law and the identifiable benefits associated with greater shareholder power both suggest that Rule 14a-11 is a sensible and appropriate response by the SEC to the status quo in U.S. corporate law. Additionally, the SEC, in promulgating Rule 14a-11, soundly explained its rationale for proposing the Rule and, in effect, satisfied the arbitrary and capricious standard under the APA. Accordingly, a court should recognize Rule 14a-11 for what it is, good administrative rulemaking, and rule in its favor. In the alternative, to partially negate the concerns inherent in the argument that Rule 14a-11 impinges on shareholders' self-determination and to foster experimentation by shareholders, the SEC should amend and adopt parameters within which shareholders could tailor proxy access to a level that is appropriate for their respective corporations.

III. THE SEC SHOULD FRAME THE PROXY ACCESS REQUIREMENTS AS PARAMETERS WITHIN WHICH SHAREHOLDERS CAN TAILOR THEIR CORPORATION'S ACCESS

The current federal proxy rules are insufficient for shareholders to have any real influence on issues of corporate governance.[251] Rule 14a-11 operates, in many ways, to update antiquated proxy rules that are seemingly based on nineteenth-century notions of the corporate form.[252] In providing access to corporations' proxy statements, the SEC gives teeth to shareholders' right of corporate suffrage, long understood to be one of

249. Purcell Statement, *supra* note 227, at 172 ("[T]he rights that we are endeavoring to assure to the stockholders are those rights that he has traditionally had under State law . . . . But those rights have been rendered largely meaningless through the process of dispersion of security ownership through[out] the country.").

250. *See supra* Part II.B.1 (analyzing Rule 14a-11 under the common-law understanding of the arbitrary and capricious standard).

251. Rodrigues, *supra* note 50, at 261 (discussing the predicament of shareholders under existing forms of corporate and federal proxy law).

252. *Cf.* BERLE & MEANS, *supra* note 33, at 2 ("The typical business unit of the 19th century was owned by individuals or small groups; was managed by them or their appointees; and was, in the main, limited in size by the personal wealth of the individuals in control.").

the few fundamental corporate rights shareholders possess.[253] Thus, a court that invalidates Rule 14a-11 as arbitrary and capricious would serve only to continue the trend of insufficient board and management accountability that was epidemic prior to the 2007 financial crisis.[254] Accordingly, this Note concludes, above all else and predicated on the above analysis, that Rule 14a-11 is simply good administrative lawmaking and should be upheld by the courts.

Nonetheless, some contend that Rule 14a-11 is too inflexible.[255] In particular, some have expressed concern with the Rule's eligibility standards[256] and the limitation on the number of board members that shareholders may nominate.[257] Therefore, as an alternative to Rule 14a-11 as currently drafted, this Part advocates that the SEC should establish parameters within which shareholders could tailor their access standards to the particular needs of their individual corporations. These more flexible windows would largely negate the alleged internal contradictions set forth above,[258] while still providing shareholders a guaranteed mode of access to the corporation's proxy materials.

Rule 14a-11 contains at least three universal limitations that the SEC should amend to provide shareholders the power to tailor access and to alleviate the criticisms commentators have lodged against it. First, Rule 14a-11 mandates that, to in-

253. *E.g.*, Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("[I]t is clear that [shareholders' right to vote] is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own.").

254. *See The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Government Oversight and Reform*, 110th Cong. 12–13 (2008) (statement of Alan Greenspan, former Chairman, Federal Reserve Board) (admitting dismay at the recklessness shown by market participants prior to the financial crisis).

255. *E.g.*, Letter from Brett H. McDonnell, Professor of Law, Univ. of Minn. Law Sch., to Elizabeth M. Murphy, Sec'y, SEC, 4–5 (Aug. 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-257.pdf (explaining why Rule 14a-11's inflexibility renders it less than optimal).

256. *See* Letter from Shearman & Sterling LLP to Elizabeth M. Murphy, Sec'y, SEC, 5–9 (Aug. 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-293.pdf (criticizing Rule 14a-11's eligibility standards).

257. *See* Letter from Brett H. McDonnell to Elizabeth M. Murphy, *supra* note 255, at 7 (suggesting that shareholders will vary on the number of directors that can be nominated using proxy access).

258. *See* Grundfest, *Internal Contradictions*, *supra* note 24, at 5–6 (contending that selectively choosing when to regard shareholders as sufficiently intelligent results in an internal contradiction in the SEC's rationale for the Rule).

voke the Rule, a nominating shareholder or group of nominating shareholders must own at least three percent "of the voting power of the company's securities that are entitled to be voted on" at a shareholder meeting.[259] Based upon data provided by the SEC, there are few individual shareholders who meet the necessary three-percent threshold.[260] Though the SEC permits the aggregation of ownership interests to satisfy the requirement, the reality of dispersed corporate ownership[261] renders such aggregations unrealistic in many instances. With that in mind, shareholders may want a lower ownership threshold. Relevant data suggest thresholds of 0.5 percent for large corporations and even 2.5 percent for smaller companies are equally ineffective.[262] Contrariwise, although a small minority of shareholders would satisfy a higher threshold such as five percent, shareholders may want to allow only aggregations of shareholders to invoke Rule 14a-11. It would therefore be sensible for shareholders to institute higher thresholds to foreclose all individual shareholders from invoking the Rule.

An additional consideration is the significant difference in ownership between large and small corporations. A large corporation such as Apple Inc., for instance, had 900,678,473 shares of Common Stock outstanding[263] and 30,573 shareholders of record as of October 16, 2009.[264] Accordingly, to invoke Rule 14a-11 an individual Apple shareholder or group of Apple shareholders would need to own at least 27,020,355 shares. In contrast, in a small, yet diversified, public corporation with hundreds, as opposed to thousands, of shareholders it would be much easier for a shareholder to achieve the Rule's three-percent threshold. Small companies would arguably therefore be exposed to a much greater number of contested elections. Consequently, although the SEC has delayed application of Rule 14a-11 to smaller reporting companies to "allow those

259. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,688 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

260. *See id.* at 56,691 (finding that thirty-three percent of nonaccelerated filers (smaller companies) and thirty-two percent of large accelerated filers (larger companies) have at least one three percent shareholder).

261. *See supra* Part I.A (discussing the ever-increasing divide and dispersal of corporate ownership in the United States).

262. Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024, 29,036 (proposed June 18, 2009) (citing statistics that show that 0.5 percent and 2.5 percent thresholds will only be satisfied by at least two shareholders ninety-nine percent and seventy-one percent of the time, respectively).

263. Apple, Inc., Annual Report (Form 10-K) 1 (Oct. 27, 2009).

264. *Id.* at 33.

companies to observe how the rule operates [and thereby] allow them to better prepare for implementation of the rules,"[265] the SEC should, as in its proposed rule,[266] establish a rule that recognizes the differences between small and large corporations.

Accordingly, the SEC should adopt an ownership threshold window of 0.5 percent to ten percent. The low 0.5-percent threshold would, in the case of a large corporation, allow at least some individual shareholders to qualify under the Rule.[267] The high ten-percent threshold, by contrast, would greatly limit the number of individual shareholders, and groups of shareholders in large corporations, from being able to invoke Rule 14a-11.[268] In short, this window would allow shareholders the greatest degree of latitude while still instituting a mandatory access regime.[269]

Second, the SEC compels a shareholder seeking to call upon Rule 14a-11 to "have held the qualifying amount of securities continuously for at least three years as of the date the nominating shareholder or group submits notice of its intent to use Rule 14a-11."[270] This includes each member of a shareholder group seeking to aggregate his ownership interests to meet the requisite ownership threshold.[271] For individual shareholders, data suggest that, at least in the broader exchange and over-the-counter markets, the average investor holds stock for less than twenty-two months.[272] Institutional investors, notably hedge funds, typically have holding periods of approximately

265. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,687 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

266. *See* Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29,035–37 (outlining tiered ownership thresholds based on whether the company is a large accelerated filer or a nonaccelerated filer).

267. *See id.* at 29,036 ("99% of large accelerated filers [as defined in Exchange Act Rule 12b-2] have two or more shareholders that each have held at least 0.5% of the shares outstanding . . . .").

268. *Cf.* Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,691 (noting that only twenty-two percent of nonaccelerated filers and sixteen percent of large accelerated filers have at least one five percent shareholder).

269. Though outside the scope of this Note, a further consideration is that a group of shareholders meaning to aggregate their shares that reach beyond the five percent ownership threshold are required to file a Form 13D with the SEC, or risk a lawsuit. *See* 15 U.S.C. § 78m(d) (2006).

270. Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,675.

271. *Id.*

272. Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 665 (1995); *cf. id.* at 621 (finding that an average investor holds shares listed on the New York Stock Exchange for less than eight months).

one year.[273] Thus, under the current form of Rule 14a-11, most individual shareholders, and many institutional investors, would not satisfy the requisite holding period. With regard to institutional investors, although there is some evidence that hedge funds, in particular, achieve significant benefits for shareholders when acting as institutional investors,[274] evidence with regard to mutual funds and pension funds suggests quite the opposite.[275] To preclude many institutional investors from being able to satisfy the Rule individually, smaller shareholders may prefer longer holding periods. Further, a number of commentators have similarly argued that shorter holding periods would encourage shareholders with a short-term focus to take advantage of the Rule and thereby divert company resources away from the company's long-term interests.[276] Therefore, the SEC, these comments argued, should adopt longer holding periods to offset such adverse consequences. Conversely, some institutional investors would prefer shorter holding periods. Thus, the SEC should adopt a window of one year to five years for shareholders to determine what works best for their particular corporation.

Finally, Rule 14a-11 states that a company "will not be required to include more than one shareholder nominee, or a number of nominees that represents up to 25% of the company's board of directors, whichever is greater."[277] The SEC rea-

273. Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1731 (2009); E-mail from Cary Klafter, Vice President, Legal & Gov't Affairs, Intel Corp., to Jonathan G. Katz, Sec'y, SEC (June 10, 2003, 18:26 EST), *reprinted in* John F. Olson et al., *Recent Developments in Federal Securities Regulation of Corporate Finance*, *in* ALI-ABA COURSE OF STUDY: POSTGRADUATE COURSE IN FEDERAL SECURITIES LAW, SJ014 ALI-ABA 1, 225–28 (2003) (commenting that data suggest that institutional investors' average holding periods are eleven months).

274. Brav et al., *supra* note 273, at 1730.

275. *See, e.g.*, Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN. 55, 69 (2007) (concluding that institutional investors' primary motives have been to enhance the value of their own investments).

276. *E.g.*, Letter from Ursula M. Burns, Chairman & Chief Exec. Officer, Xerox Corp., to Mary Schapiro, Chairman, SEC 1–3 (Aug. 23, 2010), *available at* http://sec.gov/comments/s7-10-09/s71009-700.pdf; Letter from Frederick W. Smith, Chairman & Chief Exec. Officer, FedEx Corp., to Mary L. Schapiro, Chairman, SEC 2–3 (Aug. 20, 2010), *available at* http://sec.gov/comments/s7-10-09/s71009-698.pdf; Letter from James R. Young, Chairman, President & Chief Exec. Officer, Union Pac. Corp., to Mary L. Schapiro, Chairman, SEC 2 (Aug. 20, 2010), *available at* http://sec.gov/comments/s7-10-09/s71009-696.pdf.

277. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,675 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

sons that efforts by a shareholder or group of shareholders to take control of a board or even gain more than a limited number of seats should not be funded with corporate assets.[278] On the other hand, because shareholders technically own the corporation, it is reasonable that they should determine when and if board control should change hands.[279] However, a rule that would permit shareholders to upend a majority of the board would likely lead to endlessly contested elections, resulting in the inefficient expenditure of funds and ineffective board action.[280] Accordingly, the SEC should adopt a rule that allows shareholders to tailor the change-of-power provision to anywhere from one shareholder director to a number of candidates for the board just shy of a majority, thereby eliminating fears about a rule that permits shareholders to take control of the majority of the board.

CONCLUSION

In proposing Rule 14a-11, the SEC provided shareholders with a mechanism to wield greater influence over the directors they elect and the companies they own. The Rule unlocks corporations' proxy statements to shareholders so they can nominate their own candidates for the board. As a consequence, Rule 14a-11 effectively ends boards of directors' monopoly over the director nomination process. It is likely, though, that the Rule will be challenged under the APA's arbitrary and capricious standard.

The judiciary should hold that the Rule, in its present form, is not arbitrary and capricious under the APA. However, there is an alternative to the current Rule that also works to bridge the divide between shareholder and board power. The alternative achieves the same result and fosters experimentation in shareholder proxy access, thus allowing corporate shareholders to tailor access to the needs of their individual corporation. Either alternative, however, represents a substantial and positive step away from the boards of directors' monopoly over the director nomination process in U.S. corporations.

278. *Id.* at 56,707.

279. *Cf.* Bebchuk, *supra* note 16, at 850–61 (contending that shareholders should have more power to set the rules in certain matters of corporate governance).

280. Letter from Brett H. McDonnell to Elizabeth M. Murphy, *supra* note 255, at 5 (commenting that a rule should not be too easy, or else it may lead to too many costly contested elections).