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Patty M. DeGaetano

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THE SHAREHOLDER DIRECT ACCESS TEETER-TOTTER: WILL INCREASED SHAREHOLDER VOICE IN THE DIRECTOR NOMINATION PROCESS PROTECT INVESTORS?

PATTY M. DEGAETANO*

INTRODUCTION

The two-year period of 2001-2002 will be remembered for the massive corporate and accounting scandals that impacted the United States' securities markets. In a time of rising stock market frenzy, a few giants were able to influence the financial fate of hundreds of thousands of people. Enron, WorldCom, Tyco, and Adelphia started the tidal wave—many more have fallen or are currently under investigation. Some say the regulatory reforms spawned in reaction to these scandals may be the most significant in corporate America since passage of the Securities Act of 1933 and the Securities Exchange Act of 1934.¹

Congress and the Securities and Exchange Commission (SEC) moved swiftly to pass the Sarbanes-Oxley Act of 2002 to contain the damage and begin to restore investor confidence. On its heels, additional regulatory actions were taken by the self-regulatory organizations. The New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers on behalf of the National Association of Securities Dealers Automated Quotations system each adopted new listing requirements for publicly traded companies.

* J.D., *magna cum laude*, California Western School of Law, 2004; B.S., *magna cum laude*, Business Administration-Finance, *with Distinction in Finance*, San Diego State University, 1999. I would like to thank California Western Professor Gloria Sandrino for her invaluable guidance.

1. See Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 68 (2003).

The impact of this new regulatory regime is just beginning to take hold. The ripple effect is being felt inside boardrooms as directors, executive officers, and managers scramble to comply with the new rules and pay for their corresponding costs, provide the level of real and perceived independence necessary, and show increased sensitivity to the heightened level of scrutiny on their decisions. While corporate boards are reevaluating or lowering the levels of risk they are now willing to accept, the costs of compliance with the new regulatory scheme have skyrocketed. Will these new rules adequately ensure that boards of directors will, prospectively, oversee their corporations effectively, and will those "independent" directors truly be accountable to and protect their shareholders? Time will yet tell.

Ever vigilant for the optimal level of shareholder protection, the SEC, in its role as watchdog and advocate for the investing public, has continued its quest by instituting a comprehensive review of the proxy rules. This review culminated in the July 15, 2003, Staff Report² that has prompted two new rules directly relating to members of the board.

The first rule,³ mostly favored by commentators, is now final and will provide shareholders more robust disclosure regarding the processes and considerations of the nominating committee of a public company, including the consideration of director candidates recommended by shareholders.⁴ Shareholders will hereafter know what factors impact the nominating committee's recommendations, what skills and qualities they consider necessary in a nominee, how they go about selecting the candidates, and also whether any candidate names were submitted on behalf of a five percent holder.⁵ In addition, the rule sets up a new structure that should ensure shareholders can more easily communicate with members of the board.⁶ These increased transparencies may even cause companies to reconsider how their recruitment efforts are being conducted.

2. Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, Division of Corporation Finance (July 15, 2003), *available at* <http://www.sec.gov/news/studies/proxyreport.pdf> [hereinafter Staff Report].

3. Final Rule: Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Exchange Act Release No. 33-8340 (Nov. 24, 2003), 68 Fed. Reg. 69,204 (Dec. 11, 2003) (codified in part at 17 C.F.R. § 240.14a-101), *available at* <http://www.sec.gov/rules/final/33-8340.htm> [hereinafter Nominating Committee Rule].

4. *See id.*

5. *See id.*

6. *See id.*

The second rule,⁷ highly controversial, proposes to change the paradigm by which directors of a public company can be nominated. Under certain circumstances, a company could be required to include in its proxy materials a shareholder's nominees for election as director,⁸ in effect allowing the shareholder to run a proxy battle at the company's expense. After receiving more than 14,000 comment letters on the proposed rule, the SEC is continuing to evaluate the viability and impact of this proposal.⁹ The goal of the new paradigm is to further protect investors, but whether this is the best way to accomplish this worthy goal is yet to be seen.

This article asks whether allowing individual shareholders to use company proxy materials to nominate their candidates for directors will ensure an effective method of electing a board of directors that will best protect and create value for all of the company's shareholders. The article contends that recent corporate scandals have caused both the investing community and regulatory agencies to have a heightened sensitivity to corporate governance issues. Because of this sensitivity, the theoretical battle has resurfaced between the "more is better" philosophy, which aims to increase shareholder voice and control, and the overall best interests of the corporation and all of its shareholders (i.e. the teeter-totter effect). While boards and the shareholders they serve have the same ultimate goal, they sometimes propose to go about reaching that goal differently. This article argues that the proposed shareholder direct access rule is unnecessary given the existing regulatory scheme, will not provide a meaningful new tool for shareholders, and unnecessarily preempts an area of corporate law which is adequately and traditionally regulated by state law. Furthermore, the new rule would create undue havoc if imposed while corporations are struggling to comply with the significant new burdens imposed by the Sarbanes-Oxley Act of 2002, the new self-regulatory rules and listing requirements, and the SEC's other new rules and regulations, all of which are specifically poised to address the concerns stemming from the recent corporate scandals. The new regulatory scheme is proving extremely costly in terms of both human and hard capital, and there is no clear benefit in imposing additional costs and rules on corporations that are already significantly burdened, until the effects of the existing new rules can be assessed. The pro-

7. Proposed Rule: Security Holder Director Nominations, Exchange Act Release No. 34-48626 (Oct. 14, 2003), 68 Fed. Reg. 60,784 (Oct. 23, 2003), available at <http://www.sec.gov/rules/proposed/34-48626.htm> [hereinafter Proposed Rule].

8. *Id.*

9. *Id.*

posed rule is overkill. This article suggests that because both directors and the shareholders they serve have a common goal of increasing shareholder value, through a “back to basics” framework whereby “playing fair” is the overriding concept, they can work together under the existing regulatory scheme to meet each side’s responsibilities and goals. Neither party needs to be on the down side of the teeter-totter all of the time.

Part I of this article will describe the recent corporate scandals and excesses that have understandably caused this heightened sensitivity to corporate governance issues and scrutiny of actions inside the board room, leading to a renewed call for truly independent directors. It will also explore recent trends and reforms in shareholder power and the election process, and it will outline the regulatory reforms that were the reaction to this era of scandal. Part II will dissect the Proposed Rule, which will allow security holders to participate directly in the nomination process by including a nominee in the company’s proxy materials. It will also describe related proxy and securities rules that would be impacted by the proposed security holder nomination rule. Part III will examine the Proposed Rule’s ability to protect shareholders, in light of its questionable legal authority and hurdles to practical implementation. While increased shareholder voice sounds good in theory and may serve the specific goals of a handful of shareholders, this article argues that the Proposed Rule will likely not protect all shareholders. It posits, instead, that the existing regulatory framework, much of it new and yet untested and unproven, is a sufficient framework within which shareholders and directors can work together for the best interests of their company.

I. CORPORATE SCANDALS: HISTORICAL PERSPECTIVE (2001-2002)

Enron. WorldCom. Tyco. Adelphia. These names will not be soon forgotten, even by our grandchildren. Enron and its progeny would cause an unimaginable ripple effect on the market, as tens of billions of dollars of market capital was destroyed, workers’ retirement plans were devastated, shareholders’ dreams were ruined, and individual investors’ trust in the stock market was shattered.¹⁰ These giants in corporate America have made an indelible mark on corporate history, not only because of the hundreds of thousands of people that

10. NANCY B. RAPOPORT & BALA G. DHARAN, ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS xi (2004) (collection of essays which examine the causes and consequences of Enron’s failure from business, financial, legal and ethical perspectives).

were personally impacted when they lost their life savings or when they lost the job that allowed them to put dinner on the table, but because of the sweeping regulatory reform that has been spurred on in response to their actions. The tidal wave of scandal and reactive regulation has begun.

A. *The Tidal Wave Begins*

1. *Enron Corp.*

The news flashes that broke the story “defied explanation [—] \$30 million of self-dealing by the chief financial officer, \$700 million of net earnings going up in smoke, \$1.2 billion of shareholders’ equity disappearing as if by erasure of a blackboard, more than \$4 billion in hidden liabilities—and all in a company theretofore viewed as an exemplar.”¹¹ Everyone wondered how this could happen in the shadows of a corporate governance and disclosure system said to be the envy of the world.¹²

Enron was the first in the string of recent corporate scandals that have highlighted the systemic corporate governance failures in America. It led the way for new investor demand for transparency and regulatory reform, when the market discovered that it could no longer rely on “professional ‘gatekeepers’—auditors, analysts, and others—whom the market has long trusted to filter, verify and assess complicated financial information.”¹³ In addition to challenging the belief that the United States’ corporate governance and disclosure systems were the best in the world, the Enron collapse has led many to question the belief that the United States’ capital markets, especially for large publicly traded corporations,¹⁴ are “highly efficient.”¹⁵ The Enron story is not unlike several others that followed.

11. William W. Bratton, *Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders?: Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1282 (2002).

12. *Id.*

13. John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1404-05 (2002) (discussing the necessary role of auditors and lawyers as gatekeepers to supplement the monitoring by inside corporate management, outside institutions and governmental agencies, and suggesting approaches to correct the problems which led to “gatekeeper failure” in the Enron collapse). “[G]atekeepers are reputational intermediaries who provide verification and certification services to investors,” and typically include independent auditors, debt rating agencies, securities analysts, investment bankers, and in some instances, lawyers. *Id.* at 1405.

14. A publicly traded company is one that is required to file periodic and annual reports with the SEC, pursuant to Section 13(a) of the Securities Exchange Act, 15 U.S.C. § 78m(a) (2004) [hereinafter Exchange Act], as a result of an effective registration statement for a class

The economic climate precipitating the 2001 Enron scandal contributed to the general public's attitude regarding corporate governance matters in place prior to Enron. Following the mid-1980s market decline, the securities markets had been rising steadily, due in part to the advances in technology, "computerization, the Internet, and the telecommunications boom."¹⁶ There was an air of optimism and faith in the American corporate governance system, believed to be far "superior to any other in the world."¹⁷ The steadily rising stock prices fueled the public's optimism and belief that the stock market was on a roll and that stock prices would "continue to rise 'as far as the eye [could] see.'"¹⁸ Along came Enron.

Enron Corp., led by chairman and CEO Kenneth Lay, was formed in 1985 upon the merger of Houston Natural Gas with InterNorth, a natural gas company based in Nebraska, creating the first nationwide natural gas pipeline company.¹⁹ It soon expanded into trading natural gas and other energy-related commodities, as a result of Jeff Skilling's idea for a "natural gas bank," and was eventually ranked as the seventh largest U.S. company based on revenue.²⁰ It gained an international presence as it expanded through opening offices abroad and ac-

of equity securities under Section 12 of the Exchange Act. 15 U.S.C. § 78I(a) and (g).

15. See Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 394-95 (2004). The Efficient Capital Market Hypothesis (ECMH), in its "semistrong form," suggests that share prices of public companies react quickly to reflect all publicly available information, resulting in stock prices being properly valued by the investing public. *Id.* at 396. However, one author suggests that while the ECMH is still a worthy academic theory, it was irrelevant in Enron's case because the market was "unable to penetrate the 'cloud cover' of those accounting gimmicks," thereby allowing it to hide "massive amounts of debt under a complicated matrix of thousands of special purpose entities structured as off-shore partnerships." *Id.* at 397.

16. Robert W. Hamilton, *The Seventh Annual Frankel Lecture Address: The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 6 (2003).

17. *Id.*; see also Bratton, *supra* note 11, at 1282 (commenting on views of corporate self-regulation in the 1990s).

18. Hamilton, *supra* note 16, at 6 & n.14 (citing Jacob M. Schlesinger & Nicholas Kulish, *A Century of Booms, and How They Ended—The Usual Causes of Death—Inflation and Inept Policies—Aren't Afoot in America Yet*, WALL ST. J., Feb. 1, 2000, at B1 (examining the potential end to "the great turn-of-the-millennium boom" but noting that "most folks . . . see nothing but sunny skies well into the future")). One commentator captured this same attitude by noting, "In the 1990s, corporate self-regulation [in the United States was] widely thought to have reached a high plateau of evolutionary success due to proliferating good practices and sophisticated institutional monitoring." Bratton, *supra* note 11, at 1282.

19. See Enron Milestones, July 1985, at <http://www.enron.com/corp/pressroom/milestones/frameset.html> (last visited Mar. 24, 2005); Enron Timeline, HOUS. CHRON., Jan. 17, 2002, available at <http://www.chron.com/cs/CDA/story.hts/special/enron/1127125>.

20. See Douglas M. Branson, *Enron—When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?*, 48 VILL. L. REV. 989, 996-98 (describing Enron's strategy); Gary Katz, Enron, CBC News Online (Feb. 2002), at <http://www.cbc.ca/news/features/enron.html> (on file with author).

quiring foreign companies.²¹ The Enron employees showed their optimism and confidence in the company by investing a significant portion of their 401(k) retirement plan funds in Enron's common stock, which was traded on the New York Stock Exchange (NYSE).²²

The California Public Employees' Retirement System (CalPERS) also showed its support of Enron by entering into several investment partnership contracts with Enron (named JEDI, short for Joint Energy Development Investments).²³ In 1993, CalPERS and Enron each invested \$250 million to form JEDI, an off-balance sheet joint venture investment partnership.²⁴ In 1997, Enron created Chewco Investments, L.P.,²⁵ a non-consolidated "special purpose entity"²⁶ composed of Enron executives and formed to buy out CalPERS' share of JEDI for \$383 million.²⁷ After selling its shares of JEDI, CalPERS agreed to invest in another partnership with Enron, JEDI II, in which each was to invest \$500 million.²⁸

Enron's expansion and acquisitions continued over the next several years. In June 1999, Andrew Fastow, Enron's CFO, proposed the creation of two partnerships, LJM1 in June 1999 and LJM2 in October 1999, in which he was the manager and an investor.²⁹ Enron entered

21. Enron Timeline, *supra* note 19.

22. See Katz, *supra* note 20. Despite the opportunity to invest in nineteen other investment vehicles, over sixty percent of the fund was made up of Enron stock, evidencing the employee confidence and support. *Id.*

23. See Kathleen Pender, *CalPERS Had Enron Because Many Did*, S.F. CHRON., Dec. 9, 2001, at G1, available at <http://sfgate.com/cgi-bin/article.cgi?file=/chronicle/archive/2001/12/09/BU208202.DTL> (explaining the basic financial details of CalPERS' investments in the two JEDI partnerships).

24. See William C. Powers, Jr. et al., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. 6 (Feb. 1, 2002), at <http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf> (Feb. 22, 2004) [hereinafter Powers Report].

25. Chewco was "named after the Chewbacca character in 'Star Wars.'" Pender, *supra* note 23.

26. See Powers Report, *supra* note 24, at 6-7. The Powers Report details the actions of the Enron board in reviewing and approving various partnerships, all later discovered to have been improperly accounted for. *Id.*

27. See Pender, *supra* note 23. Inquiries into the JEDI partnership followed after CalPERS sold its interest back to Enron, but "no one . . . suggested that CalPERS was involved in any wrongdoing." *Id.* In 1998, CalPERS and Enron formed JEDI II, "another private equity limited partnership." *Id.* Although CalPERS had tentatively committed \$500 million to JEDI II, it actually only invested \$156 million because of the uncertainty surrounding the energy crisis which broke out in 2000. *Id.*

28. See Pender, *supra* note 23.

29. See Powers Report, *supra* note 24, at 68-76. Fastow was to serve as both a general and limited partner for LJM1 and LJM2. See *id.* at 70-71, 74. Enron used these special purpose entities to "inflate revenues via sham 'left-hand to right-hand' transactions and [to] conceal debt." George W. Kunej, *Everything I Needed to Know About Enron I Learned in Kindergarten (and Graduate School)*, in RAPOPORT & DHARAN, *supra* note 10, at 880. Enron was

into more than twenty transactions with the two partnerships.³⁰ As time went on, the number of unconsolidated partnerships increased. In January 2000, *Fortune* magazine named Enron “The Most Innovative Company in America” for the fifth consecutive year and ranked Enron 24th in a survey listing the “100 Best Companies to Work for in America.”³¹ By March 2000, Enron was the sixth largest energy company in the world based on market capitalization, according to the Energy Financial Group.³² In February 2001, Jeffrey Skilling was named president and CEO.³³ Although several news articles questioned the profitability of Enron as well as other energy companies over the next year, Enron was named “The Most Innovative Company in America” in 2001 by *Fortune* magazine for a sixth consecutive year.³⁴

But the tide began to turn in early 2001 after inquiries by a highly-regarded firm that specialized in short-selling began to question Enron’s low profitability, indirect relationship between cash flow from operations and reported earnings, and most importantly, the “‘infamous’ partnerships.”³⁵ Then came Skilling’s “shocking announcement” that he was resigning from his post as president and CEO for “personal reasons” in August 2001, less than seven months after he began, amidst a time when he was aggressively selling his personal Enron stock.³⁶ Questions about Enron’s credibility had started to impact its stock price, which had fallen from \$80 at the beginning of the year to the low \$40s in mid-August.³⁷

Despite internal controls that were initially designed to monitor the related-party transactions, which proved to be ineffective due to lack of implementation and oversight, it was ultimately determined that the LJM transactions actually resulted in sham asset sales and

driven to “manage” its financial statements because of its need for cash and its need to maintain an investment grade credit rating. *Id.* at n.14 (citing NEAL BATSON, THE SECOND INTERIM REPORT OF NEAL BATSON, COURT-APPOINTED EXAMINER (2003), available at <http://www.enron.com/corp/por/examiner2.html>).

30. See Powers Report, *supra* note 24, at 8-17, 68-76.

31. See Enron Milestones, *supra* note 19.

32. *Id.*

33. Bethany McLean, *Why Enron Went Bust*, FORTUNE, Dec. 24, 2001, at 58.

34. See *id.* (noting that Enron was voted “Most Innovative Among Fortune’s Most Admired Companies” and that by 2000 it was the seventh-largest company on the Fortune 500).

35. *Id.* In examining Enron’s public documents, Jim Chanos from Kynikos Associates “took note of an odd and opaque mention of transactions that Enron and other ‘Entities’ had done with a ‘Related Party’ that was run by ‘a senior officer of Enron.’” *Id.* This appeared to him to be a clear conflict of interest. See *id.*

36. See *id.*; see also Press Release, Enron Corp., Enron Announces Skilling Resignation; Lay Assumes President and CEO Duties, <http://www.enron.com/corp/pressroom/releases/2001/ene/58-ENE-SkillingResignation-08-14-01-LTR.html> (Aug. 14, 2001).

37. McLean, *supra* note 33.

sham hedging transactions designed to circumvent the accounting rules.³⁸ Eventually, Enron was forced to include these off-balance sheet entities on its balance sheet, resulting in huge write-offs and a major announcement that would begin its eventual fall.³⁹

On October 16, 2001, Enron reported a quarterly loss of \$618 million and a more than \$1 billion reduction in shareholder equity.⁴⁰ In response to Wall Street's increased demands for more information about Enron's financial performance, the *Wall Street Journal* published a three-day series of articles on the Enron partnerships.⁴¹ During that same month, Enron top management had frozen employee 401k plan accounts; however, top executives were not similarly restricted and continued heavy selling of shares purchased through the company's stock option plan.⁴² Insiders reaped huge profits from personal stock sales, including \$23 million from sales in 2001 and \$70 million from redemptions for Kenneth Lay, and \$15.6 million before his resignation and \$15 million after for Jeffrey Skilling.⁴³

In November 2001, Enron filed its Form 8-K with the SEC announcing that Chewco, JEDI, and several other off-balance sheet limited partnerships should have been included in its consolidated financial statements pursuant to generally accepted accounting principals, and that it was restating its financial statements for 1997 through the first two quarters of 2001 because of an earnings overstatement amounting to \$586 million, or 20 percent.⁴⁴ By the end of November, Enron's share price had fallen from its all-time high of more than \$90 to its lowest in a decade at \$4.⁴⁵ These disclosures hastened Enron's

38. Powers Report, *supra* note 24, at 8-15.

39. Press Release, Enron Corp., Enron Reports Recurring Third Quarter Earnings of \$0.43 Per Diluted Share, <http://www.enron.com/corp/pressroom/releases/2001/ene/68-3QEarningsLtr.html> (Oct. 16, 2001).

40. *Id.*; see also Jathon Sapsford & Suzanne McGee, *Enron's Financial Troubles Reverberate to Bonds with Poor Liquidity and Credit-Rating Concerns*, WALL ST. J., Oct. 26, 2001, at C14.

41. See, e.g., John Emshwiller & Rebecca Smith, *Enron Jolt: Investments, Assets Generate Big Loss*, WALL ST. J., Oct. 17, 2001, at C1; Rebecca Smith & John R. Emshwiller, *Partnership Spurs Enron Equity Cut*, WALL ST. J., Oct. 18, 2001, at C1; Rebecca Smith & John R. Emshwiller, *Enron CFO's Partnership Had Millions in Profit*, WALL ST. J., Oct. 19, 2001, at C1.

42. Bratton, *supra* note 11, at 1293.

43. *Id.* (citing various news accounts of the story).

44. See Form 8-K filed by Enron, dated Nov. 8, 2001; Press Release, Enron, Enron Provides Additional Information About Related Party and Off-Balance Sheet Transactions; Company to Restate Earnings for 1997-2001, available at <http://www.enron.com/corp/pressroom/releases/2001/ene/78-SECReleaseLtr.html> (Nov. 8, 2001); McLean, *supra* note 33, at 58; Pender, *supra* note 23.

45. See Rebecca Smith & Robin Sidel, *Enron and Dynegy May Cut Price of Deal by 40%*, WALL ST. J., Nov. 27, 2001, at A3; Timeline: Enron (Feb. 4, 2002), at

eventual demise and prompted an investigation by the SEC. By the end of November, Standard & Poor's downgraded Enron bonds to high-risk junk bond status, and on December 2, Enron filed for protection from its creditors under Chapter 11 of the U.S. Bankruptcy Code.⁴⁶

In hindsight, Enron's fall is not as confusing or cloudy as the thousands of special purpose entities make it appear.⁴⁷ At the core was "accounting chicanery" about its off-balance sheet financing and related-party transactions, and "colossal failures" by its board in carrying out its oversight function.⁴⁸ One commentator labeled Enron's corporate governance structure as *sui generis* because of the "maddeningly unique" core facts that led to its failure.⁴⁹ Not only had Enron incorporated thousands of subsidiaries in a "complex web of off-balance sheet partnerships," the board had allowed the company's chief financial officer to head an independent entity that transacted billions of dollars of risky and volatile trades with Enron.⁵⁰ Then they allowed the senior officers to profit from these self-dealing transactions without supervising or comprehending the profits involved.⁵¹

A detailed view from inside the organization was enlightening. The Enron board formed a Special Investigative Committee in October 2001 to investigate the related-party transactions that led to the earnings restatement.⁵² The Special Committee found that the related-party transactions and accounting errors were the culmination of failures by many people at many levels, including "a flawed idea, self-enrichment by employees, inadequately-designed controls, poor implementation, inattentive oversight, simple (and not-so-simple) accounting mistakes, and overreaching in a culture that appears to have

<http://www.guardian.co.uk/print/0,3858,4342321-110384,00.html>.

46. See McLean, *supra* note 33, at 58.

47. The SEC moved swiftly to close the disclosure inadequacy highlighted by Enron and its use of off-balance sheet special purpose entities. In January 2003, the SEC adopted new final rules under Section 401(a) of the Sarbanes-Oxley Act that require additional disclosure regarding off-balance sheet arrangements and certain aggregate contractual obligations in an issuer's Management's Discussion and Analysis of Financial Conditions and Results of Operations. See generally Final Rule: Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Exchange Act Release No. 33-8182 (Jan. 28, 2003), available at <http://www.sec.gov/rules/final/33-8182.htm>; 68 Fed. Reg. 5982 (Feb. 5, 2003).

48. See Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421, 1426 & n.31 (2002).

49. See Coffee, *supra* note 13, at 1403.

50. *Id.* at 1403-04.

51. *Id.* at 1403.

52. Powers Report, *supra* note 24, at 3.

encouraged pushing the limits [, all of which] could and should have been avoided.”⁵³

The Special Committee specifically found that certain top management had personally enriched themselves by tens of millions of dollars, without providing proper disclosure to the board of their personal interests.⁵⁴ Even more importantly, it found that the company, with the assistance of its outside independent auditor, Arthur Andersen, had structured many of the related-party transactions through special purpose entities to accomplish favorable financial statement results, rather than bona fide economic objectives or risk transfer.⁵⁵ Other transactions were improperly implemented to offset losses, resulting in Enron concealing very large losses and “creating an appearance that those transactions were hedged,” when in fact they were not.⁵⁶ In addition to failing to note or take action regarding the deficiencies in Enron’s public disclosure about its related-party transactions, the Special Committee also found that Arthur Andersen failed to report its “serious reservations” about the related-party transactions to the board’s Audit and Compliance Committee and instead told the board that the disclosure was adequate and that it would issue an unqualified audit opinion.⁵⁷ It was later discovered that both Enron and Arthur Andersen engaged in document shredding to cover up the Enron fraud, and Arthur Andersen was later convicted of obstruction of justice.⁵⁸ Lastly, the Special Committee found that Enron’s outside legal counsel, Vinson & Elkins, failed to sufficiently explore the related-party disclosure.⁵⁹ This was failure in corporate governance systems and by the company’s gatekeepers, on a massive scale. For the next seven months, Enron’s billion-dollar bankruptcy proceeding

53. *Id.* at 27-28. “Though the [Special Committee’s] report presents the [board’s] action in somewhat sanitized and exculpatory fashion, it is hard to agree that a board presiding over the Enron mess discharged its oversight obligations as a practical matter.” Cunningham, *supra* note 48, at 1426 n.31.

54. Powers Report, *supra* note 24, at 3-4.

55. *Id.* at 4-5. In addition to its regular audit fees, “[Arthur] Andersen billed Enron \$5.7 million for advice in connection with the Chewco and LJM transactions alone.” *Id.* at 5. According to Enron’s 2001 proxy statement, it paid Arthur Andersen \$25 million in auditor fees and \$27 million in consulting fees. Bratton, *supra* note 11, at 1349 (citing Enron Schedule 14A, filed Mar. 21, 2000, at 13). Enron was Arthur Andersen’s second largest client nationwide, and several of Enron’s top accounting officers were former Arthur Andersen accountants. *Id.*

56. Powers Report, *supra* note 24, at 4.

57. *Id.* at 25.

58. See Flynn McRoberts et al., *Ties to Enron Blinded Andersen*, CHI. TRIB., Sept. 3, 2002, at 1; Flynn McRoberts et al., *Repeat Offender Gets Stiff Justice*, CHI. TRIB., Sept. 4, 2002, at 1.

59. Powers Report, *supra* note 24, at 26.

would hold the record for the largest in United States history.⁶⁰ But Enron was only the beginning.

2. *The Tidal Wave of Other Scandals*

Enron was evidence that the nature of “earnings management” had begun to change, as managers shifted their focus from striving to level out earnings swings to aggressively advancing the moment of revenue recognition.⁶¹ Not surprisingly, in hindsight, accounting scandals rose in response to the trend of premature revenue recognition.⁶² Managers were increasingly willing to recognize income prematurely, effectively “misappropriating” it from the proper future period in which it should have been recognized.⁶³ This willingness of managers to engage in “creative accounting” was fueled by the need to satisfy the market and the forecasts of security analysts covering the firm because even a modest earnings shortfall had the potential to produce dramatic market penalties when dissatisfied investors sold their stock.⁶⁴

The tidal wave had begun. While regulators were working to prevent further Enron-like situations and to restore investor confidence in the markets,⁶⁵ they were not quick enough. Along came WorldCom,

60. Scott Siamas, *Primary Securities Fraud Liability For Secondary Actors: Revisiting Central Bank of Denver in the Wake of Enron, WorldCom, and Arthur Andersen*, 37 U.C. DAVIS L. REV. 895, 896 (2004) (citing William F. Dietrich, *Legal and Ethical Issues for Attorneys Dealing with Financial Data: Heightened Scrutiny After the Enron and Andersen Debacle*, 1325 PLI/Corp. 925, 936 (2002)).

61. See John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 276-78 (2004) (identifying common denominators among recent cases of corporate scandal and arguing that unregulated conflicts of interest will continue to allow financial irregularities to repeat themselves).

62. See *id.* at 277.

63. *Id.*

64. *Id.*

65. During this time, the SEC was undergoing a major change in leadership. President Bush had appointed Harvey Pitt as Chairman of the SEC in mid-2001. Steven Andersen, *You Are in the . . . Waiting Game: History Predicts a Long Road to Governance Reform*, 13 CORP. LEGAL TIMES 142, Sept. 2003, at col. 1. Pitt envisioned transforming the SEC into a “kinder and gentler” agency that offered “respect and cooperation,” but was labeled a “toothless watchdog.” See Steve A. Radom, *Balkanization of Securities Regulation: The Case for Federal Preemption*, 39 TEX. J. BUS. L. 295, 301 (2003) (quoting Seth W. Feaster, *The Incredible Shrinking Stock Market*, N.Y. TIMES, July 21, 2002, at 14); Karen Tumulty, *Is Pitt’s SEC a Toothless Watchdog?*, CNN.Com (July 1, 2002), at <http://archives.cnn.com/2002/ALLPOLITICS/07/01/time.watchdog/>. However, Pitt’s tenure was filled with controversy, and some say he committed a huge “gaffe” when he suggested that former FBI director William Webster, a member of the audit committee of U.S. Technologies, a company then under investigation by the SEC for fraud, lead the newly formed Public Accounting Oversight Board. See Anderson, *supra*. Pitt’s short reign ended in a pressured resignation in November 2002. See *News in Brief: Fed Chief to Lead Accounting Oversight Board*, N.Y. L.J., Apr. 16,

parent of MCI and the nation's second-largest long-distance telephone provider.⁶⁶ Although the amount of WorldCom's financial fraud was staggering, its accounting shenanigans amounted to "a simple book-keeping trick"⁶⁷ instead of a "complex web of off-balance sheet [special purpose] partnerships."⁶⁸ During 2001 and early 2002, WorldCom incorrectly capitalized \$3.8 billion as relating to fees paid for phone line use of other telecom companies, instead of booking these charges as ordinary expenses.⁶⁹ Instead of immediately booking the current expense and thereby burdening net income, WorldCom's creative accounting treated the charges as "capital assets depreciated over many years."⁷⁰ This resulted in a misallocation of almost \$4 billion of the total \$16 billion in line costs.⁷¹ The restatement resulted in annual and quarterly losses totaling \$1.2 billion,⁷² instead of the previously reported net income of \$1.4 billion for 2001 and \$172 million for the first quarter of 2002.⁷³ In July 2002, WorldCom filed a Chapter 11 bankruptcy petition, nearly doubling the record for the largest U.S. bankruptcy proceeding, previously held by Enron.⁷⁴

Adelphia Communications Corporation and Tyco International Ltd. were quick to follow in the tide of corporate scandals. In May 2002, an investigation was launched into the activities of the founding family of Adelphia, a large cable broadcast company, for significant misuse of corporate funds relating to a series of unsuccessful family ventures.⁷⁵ Self-dealing allegations against the company and its CEO

2003, at col. 1.

66. See Shawn Young et al., *WorldCom Files for Bankruptcy; Debt, Scandal Overwhelm; Operations Set to Continue During a Reorganization*, WALL ST. J., July 22, 2002, at A3.

67. Cunningham, *supra* note 48, at 1426 n.29.

68. Coffee, *supra* note 13, at 1404; see William S. Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders*, 8 STAN. J.L. BUS. & FIN. 69, 108 (2002) (pointing to failure of the professional gatekeepers when Andersen overlooked WorldCom's \$7 billion of fraudulent accounting entries). Following the Enron scandal, WorldCom switched auditors from Andersen to KPMG, another of the then "big five" accounting firms, whose initial audit uncovered WorldCom's accounting fraud. See Peter Elstrom, *Special Report: Scandals in Corporate America; How to Hide \$3.8 Billion in Expenses*, BUS. WK., July 8, 2002, at 41.

69. See Elstrom, *supra* note 68.

70. See Cunningham, *supra* note 48, at 1426 n.29.

71. *Id.*

72. Young et al., *supra* note 66.

73. Elstrom, *supra* note 68, at 41.

74. See Young et al., *supra* note 66 (reporting WorldCom's assets listed at \$107 billion, thereby nearly doubling Enron's bankruptcy filing, which listed \$63.4 billion in assets).

75. See Press Release, Adelphia Communications Corp., *Adelphia Announces Developments Related to Issues Facing the Company* (May 17, 2002), available at <http://www.adelphia.com/about/pdf2002.cfm>; Larry Catá Backer, *The Duty to Monitor:*

John Rigas, his two sons, and other top executives included using “billions of dollars of company money for personal use, including private travel in a [company-owned] jet,” company guarantees for private loans used to purchase company stock, and “hiding \$2.3 billion in bank debt in off-balance sheet partnerships.”⁷⁶ Adelphia sought bankruptcy protection in June 2002, claiming that its filing was a direct result of its outside auditor’s professional negligence and breach of contractual duties.⁷⁷ The bankruptcy liquidator filed suit against Deloitte & Touche, the auditor, charging that Deloitte “either knew or . . . should have known of . . . the Rigas family’s self-dealing” and failed to disclose this information to Adelphia’s audit committee.⁷⁸

Later that year, Tyco, a large conglomerate, suffered severe losses when allegations came to light of its questionable financial reporting and the misuse of corporate funds by top executives to support their lavish lifestyles.⁷⁹ Tyco CEO Dennis Kozlowski and other top executives were criminally indicted for charges including tax evasion, grand larceny, enterprise corruption, falsifying business records, and securities fraud, in addition to civil charges for failing to disclose secret company loans.⁸⁰

Each of these companies engaged in fraudulent accounting or corporate practices by “cooking their books.” The fallout from these scandals subsequently “eroded the trust and confidence that is abso-

Emerging Obligations of Outside Lawyers and Auditors to Detect and Report Corporate Wrongdoing Beyond the Federal Securities Laws, 77 ST. JOHN’S L. REV. 919, 928-29 (2003).

76. See CBS MarketWatch Scandal Sheet, at http://cbs.marketwatch.com/news/features/scandal_sheet.asp#CAndersen (last visited Mar. 24, 2005) (detailing who has been charged or questioned and why, regarding recent major corporate scandals); see also Bill Bergstrom, *Adelphia Boss Took in \$67 Million; Agents Document Hefty Advances From Cable Firm*, CHI. TRIB., July 29, 2002, at 6 (stating that bills from Rigas family-owned companies, including the Buffalo Sabres professional hockey team, a furniture and interior design company, a car dealership, and a number of partnerships, were allegedly paid out of Adelphia bank accounts); Amy Borrus et al., *Corporate Probes: A Scorecard*, BUS. WK., June 10, 2002, at 42 (detailing recent corporate scandals and investigations, broken down by industry type).

77. Laurie Stewart, *Bankrupt Adelphia Sues Deloitte; Cable Company Protests Accountant’s Practices*, LEGAL INTELLIGENCER, Nov. 7, 2002, at 1.

78. *Id.*; *Koken v. Steinberg*, 825 A.2d 723, 725, 732 (Pa. Commw. Ct. 2003) (dismissing preliminary objections by Deloitte and finding that the bankruptcy liquidator’s complaint stated a cause of action for “various torts and breaches of contract in connection with [Deloitte’s] audit and actuarial services”).

79. Backer, *supra* note 75, at 929. CEO Dennis Kozlowski was suspected of spending company funds for personal purchases, including \$11 million for art and decorating an \$18 million duplex the company purchased for him in New York, and to purchase additional homes for him in Florida and New Hampshire, which were neither reported to the company’s stockholders nor “widely known within the company itself.” Kevin McCoy, *Authorities Widen Tyco Case, Look at Other Officials’ Actions*, USA TODAY, Aug. 13, 2002, at A1.

80. CBS MarketWatch Scandal Sheet, *supra* note 76.

lutely vital to the functioning of our capital markets.”⁸¹ As a result, investors became “understandably weak-kneed,” in turn causing a stock market loss of \$7 trillion in value and the disappearance of more than 1,000 companies, all in the short period from early 2000 to mid-2002.⁸² Faced with massive layoffs at Enron, WorldCom, and the like, and senior citizens who were now left with worthless retirement accounts, the newly-impooverished investing public demanded swift and strong government action.⁸³ While the relative number of companies that engaged in management dishonesty and suffered systematic failure of their internal controls and external auditing is small in both absolute terms and as a percentage of public companies, virtually all public companies would be impacted by the swift and serious reaction of Congress, the SEC, and the stock exchanges.⁸⁴

Blatant fraudulent accounting or corporate practices were not all that would mark this period in Corporate America’s history, however. Investors and the courts were becoming more sensitive to fiduciary duties and good business practices, or the lack thereof. The key role of the board of directors in “guiding the ship” through the potential tidal waves was brought to the forefront.

B. Corporate Excesses

1. Role of the Directors

An important lesson is to be learned from the scandals at Enron, WorldCom, Tyco, Adelphia, and elsewhere: “An effective board of directors is central to good corporate governance; and good corporate governance, in turn, is central to good corporate performance.”⁸⁵ Directors hold in the palms of their hands the broad trust and confidence of the shareholders, employees and creditors, who grant them authority to ensure the corporation’s success.⁸⁶ But as the board of Enron

81. Jeanne Cummings et al., *Bush Crackdown on Business Fraud Signals New Era*, WALL ST. J., July 10, 2002, at A1 (quoting Representative Patrick Toomey at a House hearing on WorldCom).

82. Feaster, *supra* note 65 (tracing the market decline according to the Wilshire 5000, which tracks all publicly traded U.S.-based companies, showing a decrease from a high value of \$17.25 trillion on March 24, 2000, to \$10.03 trillion on July 18, 2002).

83. Radom, *supra* note 65, at 301.

84. Teresa Carnell & James J. Hanks, Jr., *Shareholder Voting and Proxy Solicitation: The Fundamentals*, 37 MD. B.J. 23, 23 (2004) (explaining the complex process by which shareholders of public companies vote).

85. Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress*, in RAPOPORT & DHARAN, *supra* note 10, at 495.

86. *Id.*

and others have starkly demonstrated, an ineffectual board that does not put the interests of its shareholders first “cast[s] doubt on the entire corporate governance system.”⁸⁷

The board of directors typically has broad authority under state corporate law. Delaware is well known as the most important state for purposes of corporate law because not only are a majority of public companies incorporated there, other states look to Delaware corporate law for guidance.⁸⁸ Section 141(a) of the Delaware General Corporation Law provides that the “business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors.”⁸⁹

The director also plays a central role under federal securities laws.⁹⁰ The bulk of a board’s role is to advise management, assist in the decision-making process, improve the business’s operations, and assess promising business opportunities and other transactions.⁹¹ One of the other key roles for a public company board is monitoring management by selecting the chief executive officer and other members of the senior management team, determining their compensation, and if it should become necessary, replacing any of those persons.⁹² The set of legal constraints and duties within which the board operates recognizes both this role and a certain level of duty owed by the board, and directors can be held legally responsible for failing to adequately perform these duties.⁹³

2. Heightened Scrutiny of Director Fiduciary Duties

In the wake of recent corporate scandals, courts are scrutinizing corporate decision-making and showing a greater sensitivity to director responsibility and oversight, both in their actions and inactions. Courts are further defining the duty of good faith, a breach of which may cause the directors to lose their rights to corporate indemnifica-

87. *Id.*

88. See Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553, 553-54 (2002).

89. DEL. CODE ANN. tit. 8, § 141(a) (2004). This provision is typical of other states. See, e.g., REVISED MODEL BUS. CORP. ACT § 8.01 (1984).

90. The term “director” is defined under federal securities laws to mean “any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.” Exchange Act § 3(a)(7), 15 U.S.C. § 78c(a)(7) (2004); Securities Act of 1933 [hereinafter Securities Act], Rule 405, 17 C.F.R. § 230.405 (2004).

91. Lipton & Rosenblum, *supra* note 1, at 80.

92. *Id.*

93. *Id.*

tion and charter provisions that can limit their liability according to state law.

Directors owe a fiduciary duty to the corporation and its shareholders in carrying out their duties.⁹⁴ Courts will generally afford directors protection under the “business judgment rule” when they have acted in an informed manner, in good faith and in the best interests of the corporation, but that protection comes only upon a showing that they have exercised the requisite level of care.⁹⁵ The recent cases of *In re The Walt Disney Co. Derivative Litigation*⁹⁶ and *In re Abbott Laboratories Derivative Shareholders Litigation*⁹⁷ highlight the heightened scrutiny being fixed upon the board’s duty to its shareholders.

In *Walt Disney*, the Delaware Chancery Court denied Disney’s motion to dismiss the derivative action brought by shareholders of The Walt Disney Company. The shareholders brought suit against its board of directors, alleging that the directors breached their fiduciary duties by approving then president Michael Ovitz’s generous employment agreement and by “impliedly” approving his “non-fault termination” that resulted in a severance compensation package of approximately \$140 million.⁹⁸ The court held that if true, the shareholders’ allegations “imply that the defendant directors knew that they were making material decisions without adequate information and without adequate deliberation,” and that the directors’ alleged “conduct fell outside the protection of the business judgment rule.”⁹⁹

The *Abbott Laboratories* case is also illustrative of the increasing judicial emphasis on the duty of good faith. In this March 2003 decision,¹⁰⁰ the Seventh Circuit Court of Appeals noted that six years of noncompliance, inspections, notices and warning letters, which resulted in the FDA imposing upon Abbott the largest civil fine ever,

94. Felicia Smith, *Corporate Governance: Seasoned Companies*, 1279 PRAC. L. INST. 33RD ANN. INST. ON SEC. REG. 119, 150 (2001); see *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

95. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985) (“[U]nless it is shown by a preponderance of the evidence that the directors’ decisions were primarily based on perpetuating themselves in office, or some other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed, a Court will not substitute its judgment for that of the board.”).

96. *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003).

97. *In re Abbott Lab. Derivative S’holders Litig.*, 325 F.3d 795 (7th Cir. 2003) (applying Illinois law).

98. *Lipton & Rosenblum*, *supra* note 1, at 80 n.35 (citing *Walt Disney*, 825 A.2d at 277-78, 282-89).

99. *Id.* (quoting *Walt Disney*, 825 A.2d at 289).

100. See *Abbott Lab.*, 325 F.3d at 795.

and the destruction and suspension of \$250 million of corporate assets, supported a reasonable assumption that the board had failed to exercise its oversight duties.¹⁰¹ The court found there was a “sustained and systematic failure of the board to exercise oversight” that was “intentional in that the directors knew of the violations of law, [and] took no steps . . . to prevent or remedy the situation.”¹⁰² Accordingly, the court found “the directors’ decision to not act was not made in good faith and was contrary to the best interests of the company.”¹⁰³

Other recent cases have shown a possible shift in the previously required standard to plead and prove claims for “control person” liability under the Exchange Act. Section 20(a) of the Exchange Act imposes liability for securities violations on persons who directly or indirectly control other persons who violate the securities laws.¹⁰⁴ Among other things, this holds directors and officers liable for any false or misleading statement made by the company. *In re WorldCom, Inc. Securities Litigation*¹⁰⁵ and *In re Initial Public Offering Securities Litigation*,¹⁰⁶ both Second Circuit cases, held that “a plaintiff need not plead nor ultimately prove that [the director or officer] acted with [scienter] to be held secondarily liable” under Section 20(a)’s provision for control person liability.¹⁰⁷ Some predict that these decisions, which reversed a previous trend requiring plaintiffs to plead scienter or a culpable state of mind, will increase the likelihood of liability for control persons under Section 20(a), because the plaintiff’s burden has been lessened.¹⁰⁸

3. No One Is Above Reproach

Even the “Big Board” has been swept in by the tidal wave. Richard Grasso, chairman and chief executive officer of the New York Stock Exchange since 1995, resigned in September 2003 among pressure from the board and other exchange members after news of his

101. *Id.* at 809.

102. *Id.*

103. *Id.*

104. 15 U.S.C. § 78t(a) (2004).

105. *In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392, 415 (S.D.N.Y. 2003).

106. *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281, 396-97 (S.D.N.Y. 2003).

107. See Richard Slack & Sirin Thada, *Control Person Liability Under the Exchange Act: Possible Shift in Standard in S.D.N.Y.* (2003), at <http://www.weil.com/>.

108. *Id.* The largest number of securities class action claims is filed in the Second Circuit, making this circuit’s jurisprudence on the subject of control person liability noteworthy. *Id.* at n.2.

\$139.5 million compensation package came to light.¹⁰⁹ The SEC and the New York Attorney General launched an investigation of Grasso's total compensation award of \$188 million as being "unreasonable and not commensurate with his responsibilities" under New York's non-profit law.¹¹⁰ Instead of setting an example of ethical leadership, fitting for one hailed as an "elder statesman of the financial world," his behavior has "shaken the faith of investors and the foundation of the stock exchange."¹¹¹ In addition to reproachable conduct by the NYSE's head man, NYSE floor trading specialists were ordered to pay \$240 million in penalties and fines due to trading abuses where those specialists traded ahead of customer orders, allowing the specialists to benefit from advantageous prices and through "interpositioning."¹¹²

C. The Call for Independent Directors

The Enron debacle and the following tidal wave of scandals have led to the reemergence of the debate over the value of, and what exactly constitutes, an "independent director." Hindsight has shown that many of the Enron outside directors had ties that made them arguably not independent at all: several directors were part of "interlocking di-

109. Gretchen Morgenson & Landon Thomas, Jr., *Corporate Conduct: The Overview; Chairman Quits Stock Exchange in Furor Over Pay*, N.Y. TIMES, Sept. 18, 2003, at A1. Grasso's August 2003 employment contract provided for "payments totaling \$139.5 million in deferred compensation, savings and pension benefits," and included amounts he had deferred and accumulated over his 20 years at the exchange. *Id.* He originally came to the NYSE in 1968 as a clerk earning \$82.50 per week. *Id.*

110. Landon Thomas, Jr., *Grasso Refuses to Return Any of \$139.5 Million Pay*, N.Y. TIMES, Feb. 28, 2004, at C1 [hereinafter *Grasso Refuses*]. Grasso's compensation award included an additional \$48 million under a second contract, which he chose to forego when his pay controversy came to light. See Landon Thomas, Jr., *Market Place; Exchange Said to Want Move on Grasso Pay*, N.Y. TIMES, Jan. 8, 2004, at C1.

111. See Morgenson & Thomas, *supra* note 109. The investigation into Grasso's compensation package included a review of his conduct while serving as a director of several exchange-listed companies, including Computer Associates, where that compensation committee approved a highly controversial compensation package awarding top executives more than \$1 billion in stock, and Home Depot, where Grasso served as an interlocking director with Kenneth Langone, chairman of the NYSE's compensation committee. See Thomas, *Grasso Refuses*, *supra* note 110.

112. Landon Thomas, Jr., *Market Makers and Big Board Reach a Deal*, N.Y. TIMES, Feb. 18, 2004, at C1. The NYSE uses a 211-year-old "open outcry" trading model, whereby specialist traders on the exchange floor serve as middlemen to arrive at the best possible stock price for an investor. *Id.* Specialists are allowed to intervene in a trade using their own capital only when there is no ready buyer and seller, but exchange rules specifically prohibit them from "interpositioning," or stepping between an existing buyer and seller so that they may capture the difference between the buy and sell order. *Id.*

rectorates” in which they served together on other common boards;¹¹³ three directors were high-ranking officers of a medical center that received \$1.9 million dollars from Enron and its top management;¹¹⁴ one director was CEO of a company that did tens of millions of dollars of business with Enron units and also acquired an Enron affiliate;¹¹⁵ seven of the fourteen directors, including three audit committee members, had Enron consulting contracts, received donations to their non-profit institutions, or their companies did business with Enron;¹¹⁶ and another director served as a director of a company that was a major Enron shareholder, yet that relationship was not disclosed.¹¹⁷

Independent directors serve to curb “agency costs”—the concern that corporate officers may, at the expense of the corporation and its shareholders, be inclined to shirk their duties or otherwise act in their own self-interest.¹¹⁸ Given recent corporate scandals, the value of truly independent directors is being questioned anew.¹¹⁹ The American system of corporate governance relies on independent directors as one of the most effective devices for stockholder protection.¹²⁰ The independent director also functions as a gatekeeper, with special trust and responsibilities to the company’s shareholders. While stockholders vote for and expect proper governance from directors, our courts stand ready to enforce and hold directors accountable for that strong bond of trust shareholders vest in them.¹²¹

However, one noted view is that there is a paradox relating to the desirability of truly independent directors because, even though this is the model recommended for public companies, independent directors typically know less about the company than insiders, have less stake

113. See Christopher H. Schmitt et al., *One Cozy Bunch*, U.S. NEWS & WORLD REP., Feb. 11, 2002, at 28.

114. *Id.*

115. *Id.*

116. Mark Jaffe, *Enron Woes: The Board; Directors’ Financial Ties*, NAT’L POST, Nov. 30, 2001, available at 2001 WL 31020336.

117. Schmitt, *supra* note 113.

118. See Paredes, *supra* note 85, at 498 (citing several classic articles discussing agency costs, including Eugene F. Farma, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980), and Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)).

119. See E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—or Vice Versa?*, 149 U. PA. L. REV. 2179, 2181-82 (2001). “Under Delaware fiduciary duty law, the independence of directors becomes critical in some discrete areas. For example, two areas are interested director or controlling stockholder transactions and derivative litigation. . . . Thus, the relevant inquiries are: Independent for what purpose? Independence from whom?” *Id.*

120. *Id.* at 2180.

121. *Id.*

in decisions, and consequently “less incentive to get things right.”¹²² Conversely, one bold commentator suggests that shareholders would be better protected if we adopted the concept of a “professional independent public director,” one who would be registered and licensed by the SEC to assure sufficient financial and legal sophistication, and knowledge of corporate ethics principals, who would serve a limited term with pre-established well-paid compensation, thereby effectively serving as the “narc” among those “who would deal drugs.”¹²³

The need to crystallize exactly who is an independent director, how shareholders ensure that board seats are filled with those persons, and how those persons are selected by the company and its shareholders is now, more than ever, of interest to shareholders.

D. Shareholder Power

Prior to the adoption of the new regulatory framework created by passage of the Sarbanes-Oxley Act, the new self-regulatory organization (SRO) and SEC rules, shareholder input and director and manager responsiveness were already increasing due to prior reforms and trends.¹²⁴ These changes included increasing institutional ownership of large public companies and the SEC’s significant 1992 proxy rule amendments that enhanced shareholder communications.¹²⁵ Institutions have the potential to wield significant power over corporations because of their ownership. While U.S. pensions hold 21.5% of total corporate equities, U.S. institutions hold 49.8%.¹²⁶ In addition to this increased institutional strength, the SEC adopted major changes to its proxy and other rules in 1992 that were designed to provide more liberal shareholder communications, both among individual shareholders and between shareholders and the company.¹²⁷ The proxy amend-

122. *Id.* at 2183. Might stockholders be better off with a board dominated by insiders who have more time and incentive to do a better job? *See id.* at 2183-84. Quite possibly the optimal is a balance of independent directors and knowledgeable insiders, with no “one size fits all” when it comes to board composition. *See id.* at 2184.

123. *See* Lerach, *supra* note 68, at 107-08.

124. Lipton & Rosenblum, *supra* note 1, at 91.

125. *Id.*

126. NYSE Data Fact Book Online, at <http://www.nysedata.com/factbook/main.asp> (last visited Mar. 24, 2005). Percentages are based on latest available data, third quarter 2002.

127. Lipton & Rosenblum, *supra* note 1, at 91. *See generally* Final Rule: Regulation of Communications Among Shareholders, Exchange Act Release No. 34-31326, 57 Fed. Reg. 48,276 (Oct. 22, 1992). The SEC was concerned that the cost of complying with the proxy rules, and risk of liability for failure to comply, discouraged shareholders from communicating. Several other efforts by the SEC to enhance the shareholder communication process followed. *See, e.g.*, Final Rule: Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 34-40018 (May 21, 1998) (simplifying Rule 14a-8 by recasting it into a question

ments also permitted “short slate” election contests, i.e., proxy contests in which dissident shareholders nominate less than a full slate of directors.¹²⁸

1. *The Election Process*

The election process for corporate boards is unique to that setting and does not mimic the nation’s typical political process for electing its leaders.¹²⁹ Traditionally, the role of shareholders has been to vote for the slate of directors proposed by management.¹³⁰ However, if they were unhappy with the performance of a company’s directors, they were not powerless and could simply replace the board¹³¹ or sell the stock.¹³² But some claim the “safety valve” is missing—shareholder power is really a myth, and it is rare for a director to be replaced by shareholders because of cost and/or difficulty of waging a proxy contest.¹³³

and answer format, reversing a no-action letter position on employment-related shareholder proposals that raise social policy issues, and amending Rule 14a-4 to provide guidance to companies exercising discretionary voting authority), available at <http://www.sec.gov/rules/final/34-40018.htm>; Staff Legal Bulletin 14, Shareholder Proposals (July 13, 2001) (explaining the Rule 14a-8 no-action letter process and expressing the staff position on common issues that arise), available at <http://www.sec.gov/interp/legals/cfs1b14.htm>; Staff Legal Bulletin 14A, Shareholder Proposals (July 12, 2002) (modifying the staff position on Rule 14a-8 shareholder proposals relating to executive compensation plans), available at <http://www.sec.gov/interp/legals/cfs1b14a.htm>.

128. Lipton & Rosenblum, *supra* note 1, at 91. For an empirical analysis of the effect of the 1992 proxy reforms, see generally Stephen Choi, *Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms*, 16 J.L. ECON. & ORG. 233 (2000).

129. See Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1377 (2002).

130. Noted commentators have historically posited that management not only controls the day-to-day business of a corporation, but also the board, due to their control over the election process, thereby making the election of management-sponsored directors more assured. See Paredes, *supra* note 85, at 499 (citing ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 69-70, 87-89 (1932) (arguing that agency costs result from the separation of ownership and control that occurs when stock ownership is disbursed and boards are passive)).

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

132. The ability of all shareholders, and particularly large institutions, to freely exit corporate stock ownership is commonly referred to as the “Wall Street Walk.” See, e.g., William B. Chandler, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083, 1090-92 (1999) (arguing that institutional shareholders should not be relied on as “corporate monitors” because while institutional investors typically act to maximize share value, this may not create long-term efficiencies because their interests are not always aligned with individual shareholders).

133. Lucian Arye Bebchuk, *The Case For Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 45 (2003).

In reality, nominating committees have more power than stockholders to shape board composition.¹³⁴ Because the existing proxy process favors management's slate of directors, partially due to cost-benefit considerations, incumbent directors are almost assured to keep their slots and it is typically only in the takeover context that they would really face a challenge.¹³⁵

2. Globalization & Technology

Globalization¹³⁶ has significantly impacted the world economy and spurred more integration between national economies than ever before.¹³⁷ The United States is at the forefront of the ever-expanding global economy because of the explosion of new trade markets and improved technology in the fields of communications and transportation.¹³⁸ Through globalization, many U.S. companies have been able to achieve incredible financial success, and many multinational corporations have become "enormous economic giants with economies that rival those of many developing countries."¹³⁹

Advances in electronic communications technology have made e-mail and the Internet both less expensive and more readily available, thereby enhancing shareholders' ability to mobilize around selected issues and "to implement sophisticated, wide-scale communication programs" with other shareholders.¹⁴⁰ With globalization of the equity capital markets, corporations formed outside of the United States have also started to focus on "shareholder activism" issues such as greater transparency, good corporate governance, and democratic shareholders' principles.¹⁴¹

134. Strine, *supra* note 129, at 1377.

135. *Id.*; see also William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1094-95 & n.83 (2002).

136. The term "globalization" refers to the current "worldwide economic revolution which [extends] to all parts of the world." Frank Rene Lopez, *Corporate Social Responsibility in a Global Economy After September 11*, 55 MERCER L. REV. 739, 739 n.1 (2004). It includes activities by multinational corporations, foreign investments and international loans, and financial capital that flows between countries. *Id.* Globalization is a complex process and many entities play a role, including the World Trade Organization, the World Bank, and the International Monetary Fund. *Id.*

137. *Id.* at 739.

138. *Id.*

139. *Id.* at 739-40.

140. Smith, *supra* note 94, at 136. This author cites the example of two shareholders who met in an internet "chat room," decided to challenge management's slate of nominees, and ran a proxy contest in which they garnered 15% of the total votes cast, for a cost of \$15,000. *Id.*

141. *Id.* at 136-37.

3. *Institutional Shareholder Influence*

While the formal role of shareholders effectively limits their involvement in the ordinary business activities of a corporation, some powerful institutional shareholders have begun to use their influence to put pressure on the board and management to achieve those shareholders' objectives.¹⁴² Two of the most active institutional investors are CalPERS and the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF).¹⁴³ Pressure from institutional investors like these often comes in the form of demands that management deliver consistent financial results that conform to previously announced projections.¹⁴⁴ In addition to their own sophisticated internal research departments, these large institutional shareholders often hire outside organizations such as Institutional Shareholder Services, Investor Responsibility Research Center, or the Interfaith Center on Corporate Responsibility to assist them in analyzing management proposals, and those outside analytical organizations post on their websites their position and recommendations on specific issues.¹⁴⁵

In negotiating with the board and management toward achieving their objectives, institutional investors use their powerful leverage of voting for or withholding support for management's director nominees or other company proposals.¹⁴⁶ And such a 'withhold' vote can actually make a difference, in part because the Delaware Chancery Court has held that "withhold authority" proxy votes must be counted when determining whether a particular nominee was indeed elected by a majority of "voting power present."¹⁴⁷

E. Recent Regulatory Reforms

Congressional reaction to the Enron scandal and other business disasters proceeded quickly. Shortly after the Enron scandal erupted and the WorldCom problems hit the media, public officials started to

142. *Id.* at 133.

143. *Id.* at 133 n.24; *see also* CalPERS, at <http://www.calpers.org> (last visited Mar. 25, 2005); TIAA-CREF, at <http://www.tiaa-cref.org> (last visited Mar. 25, 2005).

144. *See* Smith, *supra* note 94, at 134.

145. *Id.* at 133 n.24.

146. *Id.* at 135.

147. *Id.* at 136; *see* North Fork Bancorporation, Inc. v. Toal, 825 A.2d 860, 869 (Del. Ch. 2000) (describing the concept of "withhold authority to vote for" as the SEC's compromise in allowing shareholders to express dissent that goes beyond merely abstaining, which is the effect that an "against" vote would normally have under state law).

speak out in favor of new and more demanding regulations and penalties.¹⁴⁸ And the news media editorial pages endorsed those ideas for increased regulation.¹⁴⁹

1. *The Sarbanes-Oxley Act of 2002*

This call for tougher regulation and penalties led Congress to hurriedly pass the Sarbanes-Oxley Act of 2002, which President Bush immediately signed into law.¹⁵⁰ The statute significantly modified existing securities laws by calling for the creation of a new regulatory oversight entity and modifying requirements for corporate disclosure and parameters for accounting procedures.¹⁵¹

2. *New NYSE & Nasdaq Listing Rules*

The SEC soon followed with its approval of final corporate governance rules and listing standards for the New York Stock Exchange and the Nasdaq on November 4, 2003.¹⁵² The NYSE and Nasdaq Listing Rules required, among other things, that listed companies¹⁵³ have independent nominating committees.¹⁵⁴

148. See Barrie McKenna, *The WorldCom Debacle: Stiffer Rules*, GLOBE & MAIL, June 27, 2002, at B5 (noting that Representative Billy Tauzin, Republican Chair of the House Energy and Commerce Committee, which headed the congressional probe of Enron, had called for "tough new laws" to restore confidence in America).

149. See, e.g., Christopher J. Dodd, Editorial, *A Law That Protects Small Investors*, WASH. POST, Feb. 2, 2002, at A23 (urging that the collapse of Enron should prompt legislators to reexamine securities and accounting laws).

150. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 & 29 U.S.C.).

151. See generally Abbe David Lowell & Kathryn C. Arnold, *Corporate Crime After 2000: A New Law Enforcement Challenge or Deja Vu?*, 40 AM. CRIM. L. REV. 219 (2003) (comparing the savings and loan crisis of the late 1980s, which prompted enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Pub. L. No. 107-73, 103 Stat. 183, with the corporate scandals that led to the passage of the Sarbanes-Oxley Act).

152. See generally Order Approving Proposed Rule Changes Relating to Corporate Governance, Exchange Act Release No. 34-48745, 68 Fed. Reg. 64,154 (Nov. 4, 2003) [hereinafter NYSE and Nasdaq Listing Rules]. The NYSE rules were codified in Section 303A of the NYSE's Listed Company Manual, available at <http://www.nyse.com/Frame-set.html?displayPage=/listed/1022221393251.html> (last visited Mar. 25, 2005) [hereinafter NYSE Manual]; see also New York Stock Exchange, Final NYSE Corporate Governance Rules (Nov. 4, 2003), available at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>. The rules governing the Nasdaq are available online at NASD Manual Online, available at, <http://nasd.complinet.com/nasd/display/index.html> (last visited Mar. 25, 2005) [hereinafter NASD Rules]. Shortly thereafter, the SEC also approved corresponding amendments to corporate governance listing requirements for the American Stock Exchange. See Exchange Act Release No. 34-48863, 68 Fed. Reg. 68,432 (Dec. 1, 2003).

153. The rules generally apply to all listed companies, but contain limited exceptions.

In addition to strengthening the standards of independence for board members, the Sarbanes-Oxley Act and NYSE and Nasdaq Listing Rules require that the board consist of a majority of independent directors, key committees (audit, governance/nominating, and compensation) consist entirely of independent directors, and audit committee members meet yet stricter standards.¹⁵⁵ The Act and rules also mandate expanded powers and responsibilities for committee members, including the requirement that a company's audit committee set the terms and compensation for the outside auditors and the company pay for any outside advisors the committee may deem advisable to hire.¹⁵⁶ In addition to their committee charters and corporate governance guidelines, companies are also required to adopt and publicly disclose their codes of conduct and ethics that govern the actions of directors, officers, and other employees.¹⁵⁷ Independent directors are required to hold executive sessions on a regular basis,¹⁵⁸ and internal mechanisms are mandated for reporting and responding to evidence of potential wrongdoing.¹⁵⁹

The new NYSE rules also require companies to disclose how shareholders may go about communicating with the company's independent directors.¹⁶⁰ So that shareholders can "make their concerns

Under the NYSE and Nasdaq Listing Rules, foreign private companies can follow home country practices in lieu of applicable listing standards, but must disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies. See NYSE Manual, *supra* note 153, § 303A-11; NASD Rules, *supra* note 153, § 4350(a).

154. Nominating Committee Rule, *supra* note 3, 68 Fed. Reg. at 69,210. While the NYSE standards include a requirement that listed companies have an independent nominating committee (NYSE Manual, *supra* note 153, § 303A.04(a)), the Nasdaq standards provide that the nomination of directors may, alternatively, be determined by a majority of the independent directors (NASD Rules, *supra* note 153, 4350(c)(4)(A)).

155. See Lipton & Rosenblum, *supra* note 1, at 88. See generally Sarbanes-Oxley Act; NYSE Manual, *supra* note 152, §§ 303A.01-.02, 303A.05(a), 303A.06-.07; NYSE and Nasdaq Listing Rules, *supra* note 152.

156. Lipton & Rosenblum, *supra* note 1, at 88; see also Sarbanes-Oxley Act, 116 Stat. at 775-77; NYSE Manual, *supra* note 153, § 303A.06.

157. Lipton & Rosenblum, *supra* note 1, at 88-89; see also NYSE Manual, *supra* note 152, §§ 303A.04(b), 303A.05(b), 303A.07(c), 303A.09-.10 (requiring companies listed on the NYSE to adopt and disclose a code of business conduct and ethics, corporate governance guidelines, and charters for nominating, compensation and audit committees); NYSE and Nasdaq Listing Rules, *supra* note 152, at 64,158 (requiring public audit, compensation and nominating committees to adopt written charters).

158. Lipton & Rosenblum, *supra* note 1, at 89; see also NYSE Manual, *supra* note 152, § 303A.03; NYSE and Nasdaq Listing Rules, *supra* note 152, at 64,158.

159. Lipton & Rosenblum, *supra* note 1, at 89; see also NYSE Manual, *supra* note 152, § 303A.10; NYSE and Nasdaq Listing Rules, *supra* note 152, at 64,159.

160. Lipton & Rosenblum, *supra* note 1, at 89; see also NYSE Manual, *supra* note 152, § 303A.03; NYSE and Nasdaq Listing Rules, *supra* note 152, at 64,158.

known to non-management directors,” the company must provide a method for the shareholder to “communicate directly and confidentially with the presiding director . . . or with non-management directors as a group.”¹⁶¹

3. *New Rule Requiring Disclosure of Nominating Committee Functions and Communication Between Security Holders and Boards of Directors*

While the NYSE and Nasdaq Listing Rules demonstrated the importance of the nominating committee and its processes and represented a “strengthening of the role and independence of the nominating committee, they [did] not require nominating committees to consider security holder nominees” or companies to make extensive disclosure regarding the operations of the committee.¹⁶² Nor did they provide specific or detailed disclosure requirements regarding the method by which security holders could communicate their concerns to non-management directors.¹⁶³

To close these gaps, on November 24, 2003, the SEC approved new proxy statement disclosure rules concerning the role of nominating committees and shareholders’ ability to communicate with boards of directors.¹⁶⁴ While the new standards do not mandate any particular action by a company or its board, they require additional disclosure intended to make the operations of a company’s board more transparent to investors and new disclosure “concerning the means, if any, by which security holders may communicate with directors.”¹⁶⁵ The “enhanced disclosure is intended to provide security holders with additional, specific information” by which to evaluate a board and its

161. See Nominating Committee Rule, *supra* note 3, 68 Fed. Reg. at 69,210; see also NYSE Manual, *supra* note 152, § 303A.03. The SEC saw this shareholder communication device as analogous to the listing standard that requires that “[e]ach audit committee . . . establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.” Nominating Committee Rule, *supra* note 3, 68 Fed. Reg. at 69,210 (quoting Exchange Act Rule 10A-3(b)(2), 17 C.F.R. § 240.10A-3(b)(3) (2003)).

162. Nominating Committee Rule, *supra* note 3, 68 Fed. Reg. at 69,210.

163. See *id.*

164. See *id.* at 69,221-22. The new rules became effective January 1, 2004, and the new disclosure requirements apply to proxy or information statements sent to security holders after January 1, 2004, and to Forms 10-Q and 10-K for periods ending after January 1, 2004. *Id.* at 69,204. Note, however, that foreign private issuers are exempt from this rule and the proxy rules generally, pursuant to the provisions of Exchange Act Rule 3a12-3, 17 C.F.R. § 240.3a12-3 (2004).

165. Nominating Committee Rule, *supra* note 3, 68 Fed. Reg. at 69,204.

nominating committee, and enhanced “transparency of the nomination process will make that process more understandable to security holders.”¹⁶⁶

a. Nominating Committee Function Disclosure

In the past, public companies were required to disclose in their annual meeting proxy statements whether they had a nominating committee and, if so, its function, the names of its members and the number of meetings it held, whether it would consider nominees recommended by security holders, and how such recommendations should be submitted.¹⁶⁷

The new Nominating Committee Rule significantly expands the disclosures relating to the director nomination process. A company is now also required to: make the nominating committee’s charter publicly available, disclose whether the nominating committee members meet SRO independence requirements, disclose whether the committee has a policy regarding considering nominees recommended by shareholders, describe the minimum qualifications for nominees recommended by the committee, describe the qualities and skills that the nominating committee believes are necessary or desirable for board members, describe the nominating committee’s process for identifying and evaluating candidates and whether fees are paid in connection therewith, disclose who recommended the nominee, and disclose the identity of any candidate nominated by a holder of more than five percent of the voting common stock, regardless of whether the nominating committee chose to nominate that candidate.¹⁶⁸ Companies must also disclose any material changes to the procedures by which shareholders may recommend director nominees to the board, including the adoption of any such procedure, in their Form 10-Q or Form 10-K reports filed with the SEC.¹⁶⁹

While the new requirements mandate only disclosure aimed at making the nominating process more transparent to shareholders and

166. *Id.* at 69,205.

167. *See id.* at 69,205 n.26 (citing Exchange Act Release No. 34-15384, 43 Fed. Reg. 58,522 (Dec. 6, 1978) (initially adopting the nominating committee disclosure standards to provide shareholders with information to assist in more informed assessment of the structure, composition and functioning of an issuer’s board)); *see also* Schedule 14A, Item 7(d)(1)-(2), of the Exchange Act, 17 C.F.R. § 240.14a-101 (2003) (amended Dec. 11, 2003) (setting forth the required proxy statement disclosure).

168. *See* Schedule 14A, Item 7(d)(1)-(2), of the Exchange Act, 17 C.F.R. § 240.14a-101 (2004).

169. *See* Nominating Committee Rule, *supra* note 3, 68 Fed. Reg. at 69,212.

do not directly impose any new requirements on how a company conducts its director nomination process, practitioners posit that the new disclosure will indirectly cause companies to change how they recruit and elect their directors.¹⁷⁰

b. Communications Between Security Holders and Directors

The Sarbanes-Oxley Act and the subsequent SEC and SRO rules have created new opportunities for shareholders to communicate with public company directors.¹⁷¹ The Nominating Committee Rule seeks to accomplish that goal through enhanced transparency of board operations and improved security holder understanding of the communication process.

To that end, this rule requires companies to provide new disclosure with regard to the process by which a security holder can communicate with board members.¹⁷² The required disclosure includes: whether the company provides a process for security holders to send communications to the board, and if so, a description of the manner in which those communications can be sent; the process for determining which, if not all, communications are relayed to board members; a description of the company's policy, if any, regarding directors' attendance at annual meetings; and a statement of the number who attended the prior year's annual meeting.¹⁷³

In lieu of providing this proxy statement disclosure, the rule allows the shareholder communication disclosure to be posted on the company's website and a reference to be made in the proxy statement to the applicable website where the information can be found.¹⁷⁴ Armed now with the ability to communicate with directors and a better understanding of the inner workings of the boardroom, the SEC hopes security holders will be empowered.

Despite the scramble public companies are currently undergoing to comply with the new requirements of the Sarbanes-Oxley Act of

170. See, e.g., Morrison & Foerster LLP, *New Proxy Statement Disclosures Regarding Director Nomination Process and Communications Between Shareholders and Boards of Directors*, Legal Updates, at <http://www.mofo.com/news/updates/files/update1130.html> (Dec. 2003); see also Hannah L. Thompson & Gregory A. Wiessner, *Public Companies Must Respond to New SEC Disclosure Requirements Regarding Nominating Committee Functions and Communications with Directors*, MONDAQ, Feb. 23, 2004 (recommending that public companies review their director nomination and shareholder communications policies and procedures in light of the Proposed Rule).

171. Morrison & Foerster, *supra* note 170.

172. See Nominating Committee Rule, *supra* note 3, 68 Fed. Reg. at 69,210.

173. *Id.* at 69,210-11.

174. *Id.* at 69,211.

2002, the new NYSE and Nasdaq Listing Rules, and the new SEC Nominating Committee Rule, the regulatory rulemaking fervor seems not yet complete. Yet another new rule—the SEC’s Security Holder Director Nominations Rule—has been proposed, and that rule is the primary focus of this article.

II. PROPOSED RULE 14A-11—SECURITY HOLDER DIRECTOR NOMINATIONS

The SEC responded to the recent corporate scandals and excesses that occurred, despite the stewardship of those companies’ boards of directors, by questioning the desirability of the directors that held those critical positions of trust and confidence. In an attempt to give shareholders a more powerful say in who those persons are and ensure director responsiveness to the shareholders they serve, the SEC is contemplating allowing shareholders of a public company to directly participate in the director nomination process by allowing them to bypass the nominating committee, nominate their choice of directors, and have those nominations included in the company’s proxy materials in certain instances.¹⁷⁵ The proposed Security Holder Director Nominations Rule (Rule 14a-11) was published for comment in October 2003¹⁷⁶ and is still in the proposal stage at this writing. If adopted in its present form, Rule 14a-11 promises to create a new paradigm that will change the way directors of a public company can be nominated for election. But will this new paradigm really protect investors?

A. *Current Director Nominations and Elections*

The federal securities laws supplement shareholder voting rights under state corporate law, as well as regulate communication among shareholders and between a corporation and its shareholders.¹⁷⁷ As a practical matter, security holders have the opportunity to vote their proxy only for those candidates nominated by the company.¹⁷⁸ Further, because many companies elect their directors by a plurality rather than a majority of votes, candidates can be elected regardless of the number of “withhold” votes they receive or whether they receive a

175. See Proposed Rule, *supra* note 7, at 60,787, 60,819.

176. See *id.* at 60,784.

177. Paredes, *supra* note 85, at 497 & n.9. The proxy rules require extensive disclosure relating to the solicitation of proxies. *Id.* For an overview of the proxy rules, see generally LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 488-561 (4th ed. 2001).

178. Proposed Rule, *supra* note 7, at 60,786.

majority of the votes cast.¹⁷⁹ Critics of the current director nomination process contend that the proxy process is ineffective and amounts to a “mere formality or ‘rubber stamp’ of the board’s choices presented in the company’s proxy materials.”¹⁸⁰ A security holder or group of security holders dissatisfied with the current directors must generally undertake a time-consuming and personally expensive proxy contest to put their nominees before the company’s security holders for a vote.¹⁸¹ Critics also argue that even though security holders can recommend a candidate, such recommendations are rarely effective, and it can be difficult to gain access to members of the board and their committees.¹⁸²

B. Shareholder Proposals Under Rule 14a-8

Existing securities laws provide a mechanism by which shareholders may, in certain circumstances, submit proposals to be included in a company’s proxy statement.¹⁸³ However, these laws do not provide a mechanism for shareholders to nominate a candidate for director. Under Rule 14a-8, any shareholder that has continuously held \$2,000 in market value or 1% of the company’s voting securities for at least one year can submit a shareholder proposal to be included in the issuer’s proxy statement and form of proxy.¹⁸⁴ However, Rule 14a-8(i)(8) allows the company to exclude a security holder proposal from its proxy statement if the proposal “relates to an election for membership on the company’s board of directors or analogous governing body.”¹⁸⁵

179. *See id.* at 60,786. “Under plurality voting, the candidate with the greatest number of votes is elected; therefore, in an election in which there are the same number of nominees as there are board positions open, each nominee receiving even a single vote will be elected, regardless of the number of votes ‘withheld’ from a candidate.” *Id.* at n.52.

180. *See id.* at 60,786.

181. *See id.*

182. *See id.*; *see also supra* notes 161-174 and accompanying text for discussion of the newly-adopted SEC rule requiring proxy statement disclosure of nominating committee functions and methods by which security holders may now communicate with a company’s directors.

183. *See generally* Exchange Act Rule 14a-8, 17 C.F.R. § 240.14a-8 (2004). For example, a shareholder may want to propose that the company stop doing business in a particular foreign country, that the company adopt an anti-discrimination employment policy, or that it redeem a poison pill or expense its management stock options. Paredes, *supra* note 85, at 497 & n.10. For an overview of the shareholder proposal process, *see generally* Loss & SELIGMAN, *supra* note 177, at 510-33.

184. Exchange Act Rule 14a-8(b)(1), 17 C.F.R. § 240.14a-8(b)(1).

185. Exchange Act Rule 14a-8(i)(8), 17 C.F.R. § 240.14a-8(i)(8). Election of directors is one of the thirteen substantive bases for exclusion allowed by the rule. *Id.*

Rule 14a-8 attempts to balance the costs to the company with the benefits to the company and its shareholders, by including modest security holder eligibility standards, limitations on the number and types of proposals, and limitations on the number of words that the company is required to include as a discussion of the security holder proposal.¹⁸⁶ The rule interacts with state law by permitting a company to exclude any proposal that would violate state law if implemented.¹⁸⁷

C. *The Proposed Rule*

The genesis of both the Nominating Committee Rule and the Proposed Rule is the July 15, 2003, SEC Staff Report undertaken at the direction of the Commission on April 14, 2003.¹⁸⁸ The Commission directed the Division of Corporation Finance to review the proxy rules and the procedures for election of directors to formulate possible changes regarding “shareholder proposals, the nomination process, elections of directors, the solicitation of proxies for director elections, contests for corporate control, and the disclosure and other requirements imposed on large shareholders and groups of shareholders.”¹⁸⁹ The report identified three particular areas of concern related to the election of corporate directors: (a) more robust disclosure was needed regarding nominating committees and the nomination process, (b) disclosure was needed regarding the process by which shareholders could communicate with board members, and (c) “conditional” access to a

186. Proposed Rule, *supra* note 7, at 60,788.

187. See Exchange Act Rule 14a-8(i)(1)-(2), 17 C.F.R. § 240.14a-8(i)(1)-(2).

188. See Press Release No. 2003-46, SEC, Commission to Review Current Proxy Rules and Regulations to Improve Corporate Democracy (Apr. 14, 2003), available at <http://www.sec.gov/news/press/2003-46.htm>. The Commission’s review was prompted, in part, in reaction to the case of a large pension plan consortium that unsuccessfully appealed its proxy proposal to the Commission. The American Federation of State, County and Municipal Employees’ Pension Plan (AFSCME) had submitted a shareholder proposal to Citigroup, Inc. that called for Citigroup to permit shareholders or groups of shareholders holding 3% or more of the company’s stock to nominate candidates for director in the company’s proxy material. *Id.* After a review of the request from Citigroup, the Division of Corporation Finance determined that existing Rule 14a-8 did not require Citigroup to include the shareholder proposal in its proxy materials. *Id.* Rather than review the staff’s determination, the Commission unanimously voted to let it stand, noting, “The current rules concerning shareholder proposals and director elections are clear and we are enforcing them as such.” *Id.* (quoting Commission Chairman William Donaldson). Nevertheless, the Commission decided to order a thorough review of the proxy rules “to ensure they were serving the best interests of today’s investors, while . . . fostering sound corporate governance and transparent business practices.” *Id.*; see also Staff Report, *supra* note 2, at 1.

189. See Press Release, *supra* note 189.

company's proxy materials was needed so shareholders could nominate director candidates.¹⁹⁰

While the Nominating Committee Rule¹⁹¹ was adopted, the SEC staff's second rule, Security Holder Director Nominations (Proposed Rule),¹⁹² which allows shareholders direct access to a company's proxy materials, has proven significantly more controversial. The SEC first published the Proposed Rule for public comment on October 14, 2003, and in response received over 12,000 initial comment letters from individuals, institutions, academia, and corporations, and several thousand additional letters.¹⁹³ Recognizing the controversial nature and uncertainties surrounding the new rule, the SEC has continued to contemplate the rule and its effects, and commentators continue to urge the SEC to move on the proposal.¹⁹⁴

1. Shareholder Nominations

The SEC's stated primary objective of the Proposed Rule is "to improve the ability of security holders to participate meaningfully in the nomination and election of directors . . . without unduly burdening

190. See Staff Report, *supra* note 2, at 33.

191. See Nominating Committee Rule, *supra* note 3.

192. See Proposed Rule, *supra* note 7.

193. Comments received by the SEC on the Proposed Rule can be found at <http://www.sec.gov/rules/proposed/s71903.shtml> (last modified Mar. 21, 2005). A summary of the comment letters can be found at <http://www.sec.gov/rules/extra/s71903summary.htm> (prepared Mar. 5, 2004).

194. Citing his concern that "the devil is in the details," Commissioner Atkins noted that the Proposed Rule is unique in that almost one-half of it consists of questions regarding implementation to which the SEC does not have detailed answers. Laura S. Pruitt, *SEC Considers Requiring Inclusion of Shareholder Nominees for Director in Company Proxy Materials*, WALLSTREETLAWYER.COM: SECURITIES IN THE ELECTRONIC AGE, Nov. 2003, WL 7 No. 6 GLWSLAW 25 (reporting various comments and views of the Commissioners expressed at the October 8, 2003, open Commission meeting at which the proposal was discussed).

Acknowledging the controversy surrounding the proposal, the SEC held a full-day "roundtable" discussion on March 10, 2004, with representatives of public companies, investor groups, and members of the legal and academic communities to discuss the Proposed Rule. A briefing paper outlining issues and questions for discussion at the roundtable is available at <http://www.sec.gov/spotlight/dir-nominations/dir-nom-briefing.htm> (Feb. 25, 2004). An unofficial transcript of the meeting is available at <http://www.sec.gov/spotlight/dir-nominations/transcript03102004.txt>, and an archived webcast of the meeting can be accessed at <http://www.connectlive.com/events/secnominations> (Mar. 10, 2004). Selected statements of roundtable participants are available at <http://www.sec.gov/spotlight/dir-nominations.htm>. While the SEC stated it would accept additional comment letters through March 31, 2004, it received several thousand additional letters and still continues to receive and post them on its website, available at <http://www.sec.gov/rules/proposed/s71903.shtml>, and a supplemental summary prepared May 25, 2004 for later letters is available at <http://www.sec.gov/rules/proposed/proposedarchive/proposed2003.shtml> (last modified Jan. 4, 2005).

companies . . . where . . . the proxy process may be ineffective.”¹⁹⁵ Once the rule is triggered, a company would be required to include information regarding a security holder “independent” nominee for election as a director in the company’s proxy materials for its annual meeting of security holders, where (a) state law establishes or does not restrict a shareholder’s right to nominate a candidate, and (b) the procedure is applicable to a particular company.¹⁹⁶

a. State Law

The security holder nomination procedure would be available unless the state law under which a company was incorporated prohibited the security holders from nominating a candidate or candidates for election as a director.¹⁹⁷ However, if state law permits a company incorporated in that state to prohibit shareholder nominations by including such a provision in its articles of incorporation and bylaws, any company that does so would make the Proposed Rule effectively unavailable to its security holders.¹⁹⁸

b. Applicability

The Proposed Rule would apply to all companies that are subject to Exchange Act proxy rules, including investment companies registered under Section 8 of the Investment Company Act; however, foreign private issuers would be exempt.¹⁹⁹ The Proposed Rule asked for comment on whether it should be applicable at first only to “accelerated filers,”²⁰⁰ and phased in later as to all other companies.²⁰¹ While the Commission expressed concern with avoiding a disproportionate

195. See Proposed Rule, *supra* note 7, at 60,816.

196. *Id.*

197. See *id.* at 60,787. This provision is set forth in the Proposed Rule at 14a-11(a)(1). *Id.* at 60,819.

198. See Proposed Rule, *supra* note 7, at 60,788.

199. See *id.* at 60,787-88 & n.59. Foreign private issuers are exempt from the SEC’s proxy rules under Exchange Act Rule 3a12-3, 17 C.F.R. § 240.3a12-3. The application of the Proposed Rule to investment companies is outside the scope of this article.

200. An “accelerated filer” is a domestic reporting company that has a public float of at least \$75 million, has been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for at least 12 calendar months, has previously filed at least one annual report under Section 13(a) or 15(d) of the Exchange Act, and is not eligible to use Exchange Act Forms 10-QSB and 10-KSB. Proposed Rule, *supra* note 7, at 60,788. Accelerated filers are subject to shortened deadlines for filing their Forms 10-Q and 10-K, and remain such until they become eligible to use Forms 10-QSB and 10-KSB for their quarterly and annual reports. *Id.*

201. See *id.*

regulation burden on smaller companies, it found that more interest in the proxy process was concentrated on the universe of companies that were accelerated filers, which might warrant a two-step phase-in approach.²⁰²

2. Triggering Events

The Proposed Rule would be triggered when either of two events have occurred, which the SEC points to as “evidence of ineffectiveness or security holder dissatisfaction with a company’s proxy process” because it has failed to permit security holder views to be adequately taken into account.²⁰³ A nomination procedure triggering event would be deemed to have occurred when (a) at least one of the company’s nominees for director receives “withhold” votes²⁰⁴ from more than 35% of the votes cast at an annual meeting at which directors were elected,²⁰⁵ or (b) a shareholder proposal pursuant to Rule 14a-8 to *activate* the shareholder “direct access” nomination procedure in Proposed Rule 14a-11 is (i) submitted for a vote of security holders at an annual meeting of security holders by a security holder or group of security holders that held more than 1% of the company’s securities entitled to vote on the proposal for at least one year,²⁰⁶ and (ii) approved by a majority of votes cast at the meeting.²⁰⁷ The nomi-

202. See *id.* Of the 266 companies that submitted no-action letters to the SEC during the 2002-2003 proxy season regarding their intention to exclude a security holder proposal under Rule 14a-8, only 26 were not accelerated filers. *Id.* Of the 14,484 companies that file periodic reports under the Exchange Act, the SEC estimates approximately 3,159 are accelerated filers. *Id.* “Therefore, while 78% of reporting companies are not ‘accelerated filers,’ less than 10% of the companies involved in the security holder proposal process at the [SEC] are not ‘accelerated filers.’” *Id.*

203. See *id.* at 60,789-90.

204. Proxy rules allow a shareholder to vote for, against, or abstain on most proposals other than in the election of directors. *Id.* at 60,789 n.72. “Because of plurality voting, in the election of directors security holders may vote for or withhold authority to vote for each nominee” *Id.*

205. This trigger would not, however, apply in the case of a contested election under Exchange Act Rule 14a-12(c), 17 C.F.R. § 240.14a-12(c), or in an election to which the proposed security holder nomination procedure under Rule 14a-11 applies. Proposed Rule, *supra* note 7, at 60,789.

206. The Proposed Rule also includes an accompanying amendment to Rule 14a-8(i)(8) clarifying that a company may not rely on the 14a-8(i)(8) exclusion for proposals relating to the election of directors in order to exclude a proposal to activate the direct access procedure proposed by Rule 14a-11. Proposed Rule, *supra* note 7, at 60,790. The Commission reiterated that it was “not reviewing or revising [its] position . . . regarding the [excludability under] Rule 14a-8(i)(8) [of] security holder proposals that would have the effect of creating a security holder nomination procedure, other than a direct access proposal.” *Id.* at n.74.

207. See *id.* at 60,789-90. “Only votes for and against the proposal would be included,” similar to the calculation under Rule 14a-8. *Id.* at n.75.

nation procedure would then remain operative for the two annual meetings following the triggering event.²⁰⁸

This process creates a two-step, two-year procedure that would be triggered in only a limited number of companies.²⁰⁹ The triggering event must first occur in year one, and the shareholder nomination right springing from that trigger is then applicable to the proxy materials for the following two years.²¹⁰ The occurrence of a nomination triggering event would require disclosure in a company's Form 10-Q or 10-K.²¹¹

While the Proposed Rule included only two triggers, the 35% "withhold" votes for a company's director nominee or approval of a direct access proposal, the Proposed Rule seeks comment on a third possible trigger.²¹² The SEC is also considering the failure of a company to *implement* a previously approved shareholder proposal submitted under Rule 14a-8,²¹³ other than a proposal for shareholder direct access, as evidence of ineffectiveness of or security holder dissatisfaction with a company's proxy process.²¹⁴

3. Eligibility Requirements

a. Nominating Security Holder Eligibility

A security holder seeking to invoke the direct access rules must meet certain eligibility requirements. The Proposed Rule requires that the shareholder or group of shareholders (a) "[b]eneficially own, either individually or in the aggregate, more than five percent of the company's securities that are eligible to vote for the election of direc-

208. *See id.* at 60,789.

209. *See id.* at 60,789-91. Based on a sample of 2,227 director elections over the past two years, the SEC estimated that "1.1% of companies had total withhold votes in excess of 35% of the votes cast." *Id.* at 60,790. In addition, of publicly traded companies, the SEC estimated that 84% have at least one institutional shareholder that has maintained ownership of at least 1% of the shares outstanding for one year. *Id.* Even so, submission of security holder proposals by large holders is rare, based on a review of a sample of 237 security holder proposals in 2002, where only three were found to have been submitted by a holder of more than 1% of the shares outstanding, and all three of those were submitted by the same security holder. *Id.* at 60,791.

210. *Id.* at 60,789-91.

211. *Id.* at 60,793.

212. *See id.* at 60,791.

213. Shareholder proposals submitted under Rule 14a-8 may be "precatory" rather than mandatory proposals, i.e., only requesting but not requiring board action, and so even though a proposal receives approval of more than 50% of the votes cast, implementation may nevertheless remain at the discretion of the board. *See id.*

214. *See id.*

tors at the next annual meeting,” (b) have held those securities continuously for a minimum of two years at the date of the nomination,²¹⁵ (c) “intend to continue to [hold] those securities through the date of the annual meeting,”²¹⁶ (d) be eligible “to report beneficial ownership [of the securities] on Exchange Act Schedule 13G, rather than Exchange Act Schedule 13D,”²¹⁷ and (e) “[h]ave filed an Exchange Act Schedule 13G or an amendment[] reporting beneficial ownership as a passive or institutional investor (or group).”²¹⁸

Shareholders are allowed to aggregate their holdings to meet the five percent minimum threshold to nominate a director candidate, and thereafter act as a concerted group to solicit for that nominee under the Proposed Rule, so long as they identify themselves and qualify to report as a Schedule 13G filer.²¹⁹ Their Schedule 13G filing would declare their intentions to form a group solely for purposes of solicitation of their director nominee, but to not otherwise seek to effect control.²²⁰ If the shareholders do not qualify to use Schedule 13G (for instance, if they intended to effect control over the company), they would not be permitted to act as a group for purposes of the Proposed Rule.²²¹

b. Nominee Eligibility

In addition to eligibility requirements for the nominating shareholder, the candidates that are nominated must also meet specified eligibility requirements. Those requirements include (a) the nomination is consistent with applicable laws and regulations,²²² (b) the nominee has no “prohibited relationships,”²²³ and (c) the nominee is “independent.”²²⁴

A company would not be required to include a security nominee if the nominee’s candidacy, or board membership if elected, would violate state or federal law or SRO rules (other than SRO rules regarding

215. See *id.* at 60,794; Exchange Act Rule 14a-11(b)(1)-(2).

216. See Proposed Rule, *supra* note 7, at 60,794; Exchange Act Rule 14a-11(b)(2).

217. See Proposed Rule, *supra* note 7, at 60,794; Exchange Act Rule 14a-11(b)(3).

218. See Proposed Rule, *supra* note 7, at 60,794; Exchange Act Rule 14a-11(b)(4).

219. See Exchange Act Rule 14a-11(b)(1)-(4); see *infra* Part II, Section D(1), and the accompanying notes, for a further discussion of Schedules 13D and 13G as they relate to the Proposed Rule.

220. See Proposed Rule, *supra* note 7, at 60,797.

221. *Id.* Existing Exchange Act Rule 14a-12(c) regarding contested elections of directors would instead apply. *Id.*

222. See *id.* at 60,795; Exchange Act Rule 14a-11(a)(3)(i).

223. See Proposed Rule, *supra* note 7, at 60,795-96.

224. See *id.* at 60,796.

independence of directors).²²⁵ Because compliance with SRO independence standards can depend on the overall make-up of a board, the SEC excluded independence standards as a separate requirement; however, the nominating security holder or group must make a representation to the company that the nominee satisfies the existing SRO standard for independence.²²⁶

While the SEC acknowledged the potential “disruptive effect a security holder nomination procedure could have on board dynamics and board operation,” and the concerns related to potential for “special interest” or “single issue” directors that would advance the interests of the nominating shareholder over the interests of all shareholders, it found the Proposed Rule would allow security holders to nominate candidates the shareholders believe are more qualified than those put forward by the nominating committee or the board.²²⁷ To compensate for this concern, however, the Proposed Rule prohibits a nominee from having certain specified relationships with the nominating security holder or group, which are essentially the same as those that currently exist under the proxy rules.²²⁸ To be considered independent, the nominee must meet the following criteria: (a) the nominee is not the security holder or a member of the nominating security holder group or an immediate family member of such person, (b) the nominee has not been an employee of the security holder or group during the current or preceding calendar year, (c) the nominee has not been a consultant to the security holder or group during the current or preceding calendar year, (d) the nominee is not an executive officer or director of the security holder or group or an affiliate of such person, and (e) the nominee does not control the security holder or group.²²⁹

To balance the concerns regarding the effect the nomination procedure may have on a company’s compliance with its “independent” director requirement and that nominating security holders may act “merely as a surrogate for the company,” against the potential benefits of the direct access procedure, the Proposed Rule requires the nominating security holder or group to represent that (a) the nominee satisfies the SRO standards regarding director independence (except where a SRO rule requires a subjective determination by the board) and (b) “[n]either the nominee nor the nominating security holder (or any

225. See *id.* at 60,795; Exchange Act Rule 14a-11(a)(4).

226. See Proposed Rule, *supra* note 7, at 60,795; Exchange Act Rule 14a-11(c)(4).

227. See Proposed Rule, *supra* note 7, at 60,795.

228. See *id.*

229. See *id.* at 60,795-96.

member of the nominating security holder group, if applicable) has a direct or indirect agreement with the company regarding the nomination of this nominee.”²³⁰

4. *Limitation on Nominations*

The company may limit the number of security holder nominees included in its proxy materials according to the size of its board. It would be required to include one nominee if its board is eight or fewer, two nominees if the board is greater than eight and less than twenty, and three if the board size is twenty or more.²³¹ For classified or “staggered” boards where the term of a director’s office extends past the date of the meeting of security holders for which the company is then soliciting proxies, the company would not be required to include security holder nominees if doing so would cause the total number of directors serving on the board that were elected as security holder nominees to exceed the previously-mentioned limits.²³²

If more security holder nominees are nominated than the allowed maximum according to board size, the nominees of the security holder with the highest ownership percentages are selected to be included in the proxy statement.²³³ The nominee or nominees of the security holder or group with the largest beneficial ownership, as reported on its Schedule 13G at the time of the nomination, would be included by the company, up to the total number required to be included.²³⁴

5. *Notice*

The nominating security holder would be required to give notice to the company of its intent to require that the company include that security holder’s nominee in the company’s proxy material no later than eighty days before the date the company mails its proxy materials for the annual meeting, and the rule sets out the content of that notice, which includes representations required by the rule, a copy of the nominating security holder or group’s Schedule 13G, and the methods by which it intends to solicit security holders, including any web site

230. *See id.* at 60,796.

231. *See id.* at 60,797. Based on a sample of 1,439 public companies in 2002, the median board size was nine, with boards ranging in size from four to twenty-four. *Id.* at n.114. Approximately 42% of boards in the sample had eight or fewer directors, 58% had between nine and nineteen directors, and less than 1% had twenty or more directors. *Id.*

232. *See id.* at 60,797-98.

233. *See id.* at 60,798.

234. *See id.* at 60,797; Exchange Act Rule 14a-11(d)(3).

address on which the nominating security holder or group may publish soliciting materials.²³⁵ A copy of the notice must be filed with the Commission and would be deemed soliciting material of the nominating security holder subject to Exchange Act Rule 14a-9.²³⁶

The company must notify the security holder or group of its determination whether or not to include the nominee in its proxy material no less than thirty calendar days before the date the company's proxy statement is released.²³⁷

6. Proxy Materials

If a security holder nominee will be included in the company proxy materials, the company must include the web site address at which the security holder or group intends to solicit in favor of its nominee, in addition to the information regarding the nominee that is required.²³⁸ If the company chooses to include a statement supporting company nominees and/or opposing the nominating security holder nominees, other than a mere recommendation to vote in favor of or withhold votes from specified candidates, the nominating security holder must be given the same opportunity to include a statement of support for its nominee or nominees, limited to 500 words.²³⁹ If the company chooses not to make any statement other than a recommendation, the company is not required to include the nominating security holder's supporting statement.²⁴⁰ In either case, both the company and the nominating security holder are allowed to solicit in favor of their nominees outside of the proxy statement (e.g., on a designated web site), provided that such solicitations otherwise comply with applicable proxy rules.²⁴¹

235. See Proposed Rule, *supra* note 7, at 60,798-99.

236. See *id.* at 60,799. Rule 14a-9 prohibits false or misleading statements in connection with solicitation of proxies. Exchange Act Rule 14a-9, 17 C.F.R. § 240.14a-9 (2004).

237. See Proposed Rule, *supra* note 7, at 60,801.

238. See *id.*

239. See *id.* The company is not liable for false or misleading statements included in either the security holder notice to the company or any security holder supporting statement that the company is required to include in its proxy materials, nor would either be considered incorporated by reference into any of the company's filings under the Securities Act or the Exchange Act, unless the company affirmatively incorporates such information. See *id.* at 60,802; Exchange Act Rule 14a-11(e).

240. See Proposed Rule, *supra* note 7, at 60,800.

241. See *id.*

7. Solicitation Activities

Because security holders wishing to form a group to meet the minimum five percent ownership threshold to nominate a director candidate may be required to engage in communications with other security holders that might otherwise be deemed “solicitations” under the proxy rules, the Proposed Rule includes a limited exemption in order to facilitate these types of communications.²⁴² To qualify for this exemption, the security holder would have two options: (a) the communications are made to no more than thirty persons, or alternatively (b) the communications can be made to an unlimited number of security holders, provided the communication is limited in content and filed with the Commission.²⁴³ The content is limited to a statement of the security holder’s intent to form a group in order to nominate a director, the percentage beneficially owned by the security holder or group, and the means by which security holders can contact the soliciting party.²⁴⁴ Solicitation communications that are aimed at forming a nominating security holder group and that comply with the foregoing requirements would generally be exempt from the other proxy solicitation rules.²⁴⁵

Once security holder groups are formed and additional solicitation activities are conducted by or on behalf of a nominating security holder or group in support of its nominee, those activities would likewise be exempt from the other proxy solicitation rules,²⁴⁶ so long as: (a) the soliciting party does not seek, directly or indirectly, the power to act as proxy, (b) each written communication includes (i) the identity of the nominating security holder or group and a description of his or her interests and (ii) a prominent legend advising security holders that a security holder nominee is or will be included in the company’s proxy statement and advising them to read the proxy statement when it becomes available, and (c) any soliciting material sent to security holders is filed with the Commission.²⁴⁷

242. See *id.* at 60,803; Exchange Act Rule 14a-11(f)(1).

243. See Proposed Rule, *supra* note 7, at 60,803.

244. See *id.*

245. See *id.* These types of soliciting activities would be exempt from Exchange Act Rules 14a-3 to 14a-6(o), 14a-8, 14a-10, and 14a-12 to 14a-15, 17 C.F.R. § 240.14a-3 to 240.14a-6(o), 240.14a-8, 240.14a-10, and 240.14a-12 to 240.14a-15 (2004). *Id.*

246. See *supra* note 245 for the applicable proxy rules from which these activities would be exempted.

247. See Proposed Rule, *supra* note 7, at 60,803.

D. Related Rule Changes

1. 5% Holder—Schedule 13G

Under Exchange Act Rule 13d-1,²⁴⁸ any person who is directly or indirectly the beneficial owner of more than five percent of a class of equity securities registered under Section 12 of the Exchange Act must report that ownership by filing an Exchange Act Schedule 13D with the Commission.²⁴⁹ Certain exceptions to this requirement permit security holders to report their ownership on Exchange Act Schedule 13G, if, for example, (a) the holder is one of a specified list of qualified institutional investors who has acquired the securities in the ordinary course of business and with neither the purpose nor the effect of changing or influencing control of the company, or (b) the holder has acquired the securities with neither the purpose nor the effect of changing or influencing control of the company, and the holder is not directly or indirectly the beneficial owner of twenty percent or more of the subject class of securities.²⁵⁰

The Proposed Rule relies heavily on the “passive investor” requirement on which Schedule 13G eligibility is based.²⁵¹ In order to be eligible to invoke the nominating procedure, the security holder or group must be eligible to report their ownership interests on Schedule 13G (rather than Schedule 13D), and the security holder or group would be required to have filed the schedule by the date the nominating security holder or group submits its notice of intent to nominate a director to the company.²⁵² The rule is premised on the SEC’s belief that passive investors which have acquired securities without the purpose or effect of changing or influencing control of the company, or qualified institutional investors which have acquired the securities in the ordinary course of business, should not be viewed as changing their intent simply by engaging in activities as part of a nominating security holder group.²⁵³

To effect the functioning of the Proposed Rule, Exchange Act Schedule 13G would also be amended to require security holders or groups to certify in their original or amended filing that they have owned at least the minimum five percent of securities for not less than

248. 17 C.F.R. § 240.13d-1 (2005).

249. *See id.*

250. *See, e.g.*, Exchange Act Rules 13d-1(b)-(c).

251. Proposed Rule, *supra* note 7, at 60,805.

252. *See id.*

253. *See id.*

two years, pursuant to Rule 14a-11.²⁵⁴ Upon termination of the nominating security holder group, a termination filing would be made.²⁵⁵

2. 10% Holders & Insiders—Section 16

Exchange Act Section 16 applies to every person that is the beneficial owner of more than 10% of any class of equity securities registered under Section 12 of the Exchange Act (10% owners), and each officer and director (collectively with 10% owners, referred to as insiders) of the issuer of such security.²⁵⁶ Section 16(a) requires insiders to file initial reports with the Commission to disclose their beneficial ownership of equity securities of the issuer, and to file reports of changes in such holdings.²⁵⁷ Section 16(b) provides a private right of action to recover from an insider any profit realized by that insider from the purchase and sale of the issuer's equity securities effect in any period of less than six months.²⁵⁸ Finally, Section 16(c) prohibits an insider from selling any equity security of the issuer if the insider does not own the security, or owns the security but does not deliver it against the sale within a specified time period.²⁵⁹

The Proposed Rule would not compel a reassessment of 10% beneficial owner status for purposes of Section 16 when security holder groups form solely for the purpose of nominating a director under Rule 14a-11.²⁶⁰ The rule is premised on the SEC's belief that the actions of nominating security holder groups are fully disclosed, they are not acting with a "control" purpose, and they do not have insider status.²⁶¹ Further, it would be a disincentive to using the Proposed Rule if forming a nominating security holder group would subject the group members to Exchange Act Section 16 if the group owned over 10% of the company's securities.²⁶²

The Proposed Rule includes an amendment to Exchange Act Rule 16a-1(a)(1) to exclude nominating security holder groups from the definition of a 10% owner for Section 16 purposes and to clarify that nominating security holder groups would not be deemed to have a

254. *See id.* at 60,806.

255. *See id.* at 60,806.

256. *See* 15 U.S.C. § 78p (2004).

257. *See id.* § 78p(a).

258. *See id.* § 78p(b).

259. *See id.* § 78p(c).

260. *See* Proposed Rule, *supra* note 7, at 60,807.

261. *See id.*

262. *See id.*

control purpose or effect solely by virtue of group membership.²⁶³ However, group members whose individual ownership exceeds 10% will continue to be subject to Section 16, as will groups whose ownership has the purpose or effect of changing or influencing control of the issuer.²⁶⁴

E. A Look Back

The Proposed Rule is one of several instances where the SEC has considered giving shareholders direct access to company proxy materials for the nomination process. As early as 1942, the Commission solicited comments on a staff recommendation that “minority stockholders be given an opportunity to use the management’s proxy materials in support of their own nominees for directorships,” but the proposal was dismissed with little explanation in the record.²⁶⁵ In 1977, the Commission again considered the proposal during its broad review of security holder communications, the corporate electoral process, and corporate governance generally.²⁶⁶ However, at the end of the day, it simply required that companies state whether they had a nominating committee, and if so, whether the committee would consider security holder recommendations.²⁶⁷

A later 1980 Staff Report to the Senate concluded that due to the emerging concept of nominating committees, the Commission should *not* propose or adopt a security holder nomination process at that time, but instead recommended that the staff monitor the development of nominating committees and their consideration of security holder recommendations.²⁶⁸ The Staff Report cautioned that if an insufficient number of companies adopted nominating committees or if the responsiveness of the committees proved insufficient, the Commission might want to reconsider action.²⁶⁹

Finally, in connection with sweeping 1992 proxy reforms,²⁷⁰ “the Commission noted ‘the difficulty experienced by shareholders in gaining a voice in determining the composition of the board,’” but con-

263. *See id.*

264. *See id.*

265. *See id.* at 60,785 (citing Exchange Act Release No. 34-3347 (Dec. 18, 1942)).

266. *See Proposed Rule, supra* note 7, at 60,785 (citing Exchange Act Release No. 34-14970, 43 Fed. Reg. 31,945 (July 18, 1978) and Exchange Act Release No. 34-15384, 43 Fed. Reg. 58,522 (Dec. 6, 1978)).

267. *Id.*

268. *See Proposed Rule, supra* note 7, at 60,785.

269. *See id.*

270. *See generally* Release No. 34-31326, 57 Fed. Reg. 48,276 (Oct. 22, 1992).

cluded that such a proposal would represent a *substantial change* in the Commission's rules which would essentially mandate a "universal ballot" including both management nominees and independent candidates for board seats.²⁷¹ Rather than mandating the universal ballot, the Commission revised the proxy rules to allow security holders seeking minority board representation to fill out a partial or "short slate" with management nominees, making it easier to conduct an election contest in a non-control context.²⁷²

F. A Look Forward

It seems clear the Proposed Rule, if adopted, will significantly reform the proxy rules and give shareholders more voice and control over the constituency of the board of directors. Yet not so clear is whether that increased voice and control will prevent the corporate and accounting scandals of our recent past and actually lead to protection for all shareholders, or only for a select few.

III. PROTECTING SHAREHOLDERS

A. *The Lesson of Selecting the "Right" Directors*

Enron and its progeny taught us that irrespective of statutory or common law fiduciary duties of care and loyalty owed by a company's directors, shareholders are wise to carefully consider those persons that are ultimately selected as directors to perform the important role of appointing management, determining management's compensation, and reviewing and approving a company's major investments and the operational decisions made by management. It may no longer be a satisfactory practice to blindly rely on management and the incumbent directors to identify and select qualified nominee directors, and more shareholder input into the director selection process may indeed be the wiser course. While heightened fiduciary duties and true independence are certainly good benchmarks, they can be hollow concepts if a corporate scandal is allowed to go unchecked and a company's stock value is all but destroyed before the shareholders are made aware of the problem. And we have seen how quickly this can

271. See Proposed Rule, *supra* note 7, at 60,786.

272. See *id.* For example, if a shareholder wanted to nominate two candidates to a seven member board, pursuant to Exchange Act Rule 14a-4(d), the holder would complete the management ballot to oppose two names, then disseminate and file a separate proxy statement and proxy card, and include a vote for the five management nominees on the non-management proxy card. *Id.*

happen. Therefore, the call for increased shareholder voice into the nomination and election of directors is certainly understandable. Shareholders may be better protected by taking a more active and earlier role in protecting their investments, and that protection may start at the point of director selection and nomination.

B. Will Proposed Rule 14a-11 Be the Cure?

Increased shareholder voice may come at a cost to some shareholders if it is not proven to effectively benefit all shareholders. Part III of this article explores the impact of the Proposed Rule and whether it will indeed result in the election of a board that will best protect all shareholders. The article concludes that the rule is not likely to result in better protection because, in addition to being unlikely to withstand judicial scrutiny, it will not provide a meaningful new tool for shareholders. The thresholds, triggers and time periods are too great for the rule to be effective, and it will not produce better boards. Instead, this article suggests that shareholders and nominating committees are currently armed with the right tools, recently provided by the new regulatory framework still “hot off the presses,” and can work together with these new tools toward their common goals of increasing shareholder value and protecting investors.

C. Fundamental Opposing Views

Even opposing sides of the shareholder access proposal agree that good corporate governance, better safeguards, and enhanced long-term value of a company’s stock are mutual penultimate goals. However, at the heart of the shareholder direct access proposal seem to be fundamental opposing views of how to reach those goals: (a) increased shareholder voice in the nominating process would improve the director selection process, resulting in directors that are more responsive to shareholders, and that would in turn ensure the recent round of corporate scandals will not reoccur, versus (b) truly independent directors who operate under an umbrella of heightened corporate governance standards would be best able to protect and serve the interests of all shareholders.

However, several questions arise from these opposing views and seem as of yet unanswered. Does who nominates the director translate into more independence? While independent directors are a central tenet of our corporate governance system, does independence corre-

late with being accountable to shareholders? And, while the shareholder direct access proposal will indeed increase shareholder voice in the selection of directors, does more voice translate into protection for all shareholders? Or will that protection come at an unacceptably high cost in terms of board distraction and dissention?

These questions will not likely be answered in the immediate future. We have only recently adopted a new corporate governance regulatory scheme, the most significant in more than a half a century, and it needs some time to prove itself and whether these questions will be answered. However, instead of giving the new scheme time, the SEC proposes to add another rule on top of the many. Yet, assuming it withstands judicial scrutiny, the shareholder direct access rule will result in a proxy nomination process that is more disruptive and expensive and inner workings of the boardroom that are more adversarial. Is this “good” for shareholders? While this type of proposal may be appropriate for a minute number of the “worst” companies, as structured it will apply to all of the more than 14,000 public companies, so it is appropriate to carefully consider its impact.

D. No Authority to Regulate Corporate Governance and Preempt State Law

If adopted in its present form, the Proposed Rule will likely be judicially challenged because it appears to exceed the SEC’s established authority. It goes beyond regulating disclosure and into the area of substantive corporate governance. Moreover, it effectively preempts state law in an area of corporate governance traditionally regulated exclusively by the states, without any clear authority to do so. Consequently, there appears to be no precedent for the SEC to unilaterally expand its authority to include substantive powers in the area of director nominations.

1. Coexisting Federal and State Law Paradigms

A mix of federal and state law governs public companies. State law has traditionally and exclusively regulated the area of director elections.²⁷³ Through the company’s charter documents, the company

273. The U.S. Supreme Court has said, “Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.” *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977) (citing *Cort v. Ash*, 422 U.S. 66, 84 (1975)).

grants rights to its shareholders consistent with the laws of the state in which it incorporates.²⁷⁴ And while over 50% of public companies are incorporated in Delaware, known for its expertise on corporate law issues, other states vie for the remaining corporate charter business and are understandably sensitive to corporate governance issues and needs when crafting their particular state corporate laws.²⁷⁵

Under the Exchange Act, the SEC has broad federal authority to mandate disclosure by public companies in their periodic reports, proxy materials and other filings, for matters that are material to shareholder voting, other decisions, and corporate governance matters.²⁷⁶ However, rules promulgated under the SEC's authority to regulate the proxy solicitation process must be deemed "necessary or appropriate in the public interest or for the protection of investors."²⁷⁷

2. *Beyond SEC's Authority—The Critical Distinction Between Mandating Disclosure Requirements and Regulating Corporate Governance*

Section 14(a) of the Exchange Act limits the SEC's power to promulgate rules to those that relate to disclosure and procedures connected with the solicitation of proxies. While one view is that the Proposed Rule merely mandates what material appears in a company's proxy statement, it actually impacts who can nominate, how they nominate, and who is eventually elected—actions that cross the line from disclosure and move into the area of substantive corporate governance. There is a significant distinction between mandating disclosure and regulating the nomination process, and the seminal case of *Business Roundtable v. SEC*²⁷⁸ has given guidance on this distinction.

First, some background may be helpful on several sources of the SEC's rule-making authority. The SEC's power to promulgate rules under the Exchange Act oftentimes translates into exchange listing standards that are adopted to implement those rules.²⁷⁹ The SEC must

274. See *Cort*, 422 U.S. at 83-84.

275. See *Bebchuk & Hamdani*, *supra* note 88, at 553-55 (collecting data and considering whether regulatory competition among the states serves to increase shareholder value).

276. See generally Exchange Act §§ 13-14, 15 U.S.C. § 78m-n (2004); see also Special Study Group of Committee on Federal Regulation of Securities of the American Bar Association Section of Business Law, *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1529 (2002) (examining the role and authority of the SROs and the SEC in matters of corporate governance, and recommending a proposal to develop best practices guidelines and implement a "comply or explain" approach).

277. See Exchange Act § 14(a), 15 U.S.C. 78n(a) (2004).

278. 905 F.2d 406 (D.C. Cir. 1990).

279. For a broad discussion of SEC authority relating to listing standards, see generally

approve any new or amended listing standards adopted by the exchanges or Nasdaq.²⁸⁰ The SEC's authority emanates from Sections 19(b) and (c) of the Exchange Act, and differs depending on whether the standard is proposed by the SRO or the SEC is imposing the standard on the SRO.²⁸¹ Under Section 19(b), listing standards that are proposed by the SROs must be "consistent with the requirements" of the Exchange Act applicable to the SROs, while under Section 19(c), listing standards that are imposed by the SEC on the SRO must be "necessary or appropriate . . . in furtherance of the purposes" of the Exchange Act.²⁸²

The "consistency test" of Section 19(b) requires that SRO rules may not "permit unfair discrimination between . . . issuers."²⁸³ While there has yet been no judicial consideration of the SEC's authority under Section 19(b), *Business Roundtable* has interpreted the SEC's lack of power to promulgate corporate governance listing standards under Section 19(c).²⁸⁴

In *Business Roundtable*, the D.C. Circuit Court of Appeals abrogated SEC-adopted Exchange Act Rule 19c-4, which attempted to bar the exchanges and Nasdaq from listing securities with certain disparate voting requirements, on the ground that it sought to "directly control the substantive allocation of powers among classes of shareholders" and therefore exceeded the SEC authority under Section 19.²⁸⁵ The court held the rule was not "'in furtherance of the purposes' of the Exchange Act"²⁸⁶ and concluded that the SEC had stepped beyond control over voting procedure and into the distribution of voting power.²⁸⁷ The court did not find expressly enumerated power for the SEC to regulate this area of corporate governance, nor would it infer any expanded power. The court found no congressional intent to permit broad federal preemption over corporate governance standards, nor the intent to create a comprehensive body of federal corporate law

Special Study Group, *supra* note 276, at 1487.

280. See Exchange Act § 19(b), 15 U.S.C. § 78s (2004).

281. Task Force on Shareholder Proposals of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association, *Report on Proposed Changes in Proxy Rules and Regulations Regarding Procedures for the Election of Corporate Directors*, 59 BUS. LAW. 109, 131 (2003) (report prepared in response to SEC's request for comments concerning regulation of shareholder proposals and shareholder participation in the director selection process).

282. *Id.* See Exchange Act § 19(b)-(c), 15 U.S.C. § 78s (2004).

283. See Exchange Act § 6(b)(5), 15 U.S.C. § 78f(b)(5) (2004).

284. Task Force on Shareholder Proposals, *supra* note 281, at 132.

285. 905 F.2d 406, 407 (D.C. Cir. 1990).

286. *Id.* at 417.

287. *Id.* at 411.

through mandated listing standards, which would impinge on the traditional state regulation of corporate law.²⁸⁸ While the SEC has not sought to invoke Section 19(c) authority since *Business Roundtable*, its powers of persuasion appear nonetheless effective in enlisting the cooperation of SROs to coordinate amended listing standards.²⁸⁹

The *Business Roundtable* decision preceded the recent corporate scandals that led Congress to adopt the Sarbanes-Oxley Act. When it did so, Congress included in that Act express authority for the SEC to promulgate rules in specific areas of corporate governance, which the SEC and SROs have now done. However, the Sarbanes-Oxley Act did not contemplate or address the topic of director nominations. The Act does not express Congress's intent to grant authority to the SEC in this area, nor does the Proposed Rule cite Sarbanes-Oxley for its authority, which further confirms that the SEC lacks express congressional authority to regulate the area of director nominations.

Notably, the Proposed Rule is virtually silent on the basis for its statutory authority and simply states "we believe that today's proposals further the goals of Section 14," and "the proposed procedure involves disclosure and other requirements concerning proxy materials."²⁹⁰ It also asserts "a similar underlying purpose as Exchange Act Rule 14a-8" in that "the proposal would establish a procedure pursuant to which a company would have to provide specified information regarding [a shareholder] nomination in its proxy materials."²⁹¹ Based solely on these general statements and with no other basis for its authority, the Proposed Rule states that it is authorized by "Sections 3(b), 10, 13, 14, 15, 16, 23(a) and 36 of the Securities Exchange Act of 1934" and similar provisions of the Investment Company Act of 1940.²⁹² However, the Exchange Act does not authorize the SEC to

288. *See id.* at 412-13. As examples of corporate governance matters which were reserved to the state, the court cited "requirements for independent directors, independent audit committees, shareholder quorums, shareholder approval for certain major corporate transactions, and other major issues traditionally governed by state law." *Id.* at 412.

289. *See* Special Study Group, *supra* note 276, at 1526.

290. Proposed Rule, *supra* note 7, at 60,786-87.

291. *Id.* at 60,788.

292. *Id.* at 60,816. However, under seminal case law, the SEC's assessment of its own authority is not entitled to deference under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844-45 (1984). *See, e.g.*, *United Transp. Union-Illinois Legislative Bd. v. Surface Transp. Bd.*, 169 F.3d 474, 477 (7th Cir. 1999) ("We have indeed held that an administrative agency's determination about the scope of its own jurisdiction, 'a matter within the peculiar expertise of the courts,' does not receive *Chevron* deference but is reviewed *de novo*." (citing *Midland Coal Co. v. Dir., Office of Workers' Comp. Programs*, 149 F.3d 558, 561 (7th Cir. 1998) (internal citation omitted) (*Chevron* deference "does not extend" to questions of an agency's jurisdiction)).

regulate the internal affairs of a corporation by setting the qualifications of directors who may be nominated or by giving shareholders greater ability to change the makeup of the board. Therefore, the Proposed Rule is outside the SEC's current scope of authority and likely will not withstand a judicial challenge.

3. State Law Preemption

State corporate law governs the director nomination and election process.²⁹³ The Proposed Rule seeks to regulate corporate governance in a manner in which the U.S. Supreme Court has declared reserved to the states.²⁹⁴ The SEC does not have the power to exercise unilateral discretion to adopt regulations that preempt state laws.²⁹⁵ As *Business Roundtable* tells us, "the SEC's assertion of authority directly invades the 'firmly established' state jurisdiction over corporate governance and shareholder voting."²⁹⁶ While the Proposed Rule specifies the nomination right would only apply to companies whose charter documents do not prohibit its provisions, and to companies that are incorporated in states which allow its provisions, the shareholder direct access rule essentially preempts state law in the area of director nomination rights and voting processes by creating new federal practices that run counter to the concept of federalism. The SEC seems to have acknowledged the potential state law preemption issue by asking for comments on whether the Proposed Rule would conflict with state law or SRO regulations.

Moreover, extending the rationale of *Business Roundtable* to the Proposed Rule, there is no express congressional intent to allow the SEC to preempt state corporate governance measures on who can nominate directors or impose triggering events allowing a nomination to be made, and what criteria that nominating shareholder must meet. Just as Rule 19c-4 impermissibly sought to substantively control the allocation of power between shareholders, the Proposed Rule will control, and actually grant, power to large shareholders to name a nominee and have the company pay for and distribute proxy materials promoting that candidate, yet small shareholders will have no such power

293. See, e.g., DEL. CODE ANN. tit. 8, §§ 141, 211-12 (2004) (governing election of directors).

294. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977) (finding that established state policies and laws govern the internal affairs of a corporation).

295. *Id.*

296. *Bus. Roundtable*, 905 F.2d at 413 (quoting *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 89 (1987)).

or right. This will go beyond state law rights and provide new and different federal shareholder rights.²⁹⁷

Furthermore, it is important to note a distinction between the Proposed Rule and Rule 14a-8. The latter requires certain shareholder proposals be included in proxy materials, but even a shareholder proposal that receives a majority vote is not required to be implemented, because the board retains its state law power to determine in its discretion and in the exercise of its business judgment whether the proposal would be in the best interests of the company and its shareholders. Conversely, the Proposed Rule appears to require that the shareholder nominee receiving the requisite vote have complied with the Proposed Rule and satisfied its procedural requirements.²⁹⁸ This goes beyond providing information to shareholders about what issues are to be voted upon and instead dictates what action the corporation must take, overriding the board's fiduciary duties to manage the company's business and affairs as it determines is most proper.

4. Uneven Application

The Proposed Rule will discriminate among shareholders and has the potential to result in dissent among them. It favors large shareholders, to the detriment of small holders, by granting large shareholders nominating rights that others do not have. Moreover, large shareholders will have more leverage to coerce a company into appeasing a holder's special interests in exchange for the holder withdrawing a nominee or direct access proposal. Small shareholders have no such rights or ability. Similar to the securities class action arena, this rule positions large shareholders to be able to intimidate and coerce a company's management.

Just as cumulative voting and supermajority voting requirements have fallen into disfavor,²⁹⁹ so should this rule—it gives certain

297. Query: Are we moving toward the concept of a "creature of federal law" here? Canada has such a federal incorporation option, where firms can choose to incorporate either in one of the provinces or federally. For discussion of the Canadian federal option, see generally Douglas Cumming & Jeffrey MacIntosh, *The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law*, 20 INT'L REV. L. & ECON. 141 (2000).

298. See Proposed Rule, *supra* note 7, at 60,800.

299. According to Investor Responsibility Research Center, only 9.2% of the S&P Super 1500 companies still have cumulative voting. Robert C. Pozen, *Institutional Perspective on Shareholder Nominations of Corporate Directors*, 59 BUS. LAW. 95, 107 n.44 (2003) (citing IRRIC Corporate Governance Service 2003, BACKGROUND REPORT F: CONFIDENTIAL AND CUMULATIVE VOTING (Jan. 2003)). Cumulative voting is mandatory in seven states; it is the default provision unless the corporation opts out in fourteen states; and it is not allowed unless the corporation opts in in twenty-nine states. *Id.* at 108 n.45. Institutional Shareholder Services (ISS), the leading provider of proxy voting and corporate governance services, rec-

shares/shareholders more power than others in the selection and nomination of directors.

E. Not a Meaningful Tool

Because of the nearly insurmountable obstacles the Proposed Rule contains, it is not likely to improve the director selection process or have a practical effect of protecting shareholders.

1. Thresholds and Triggers Are Too High to Be Effective

The five percent threshold to nominate a director is too high to be effective. The United States stock market is fragmented and has a low concentration of share ownership. Less than one-half of the companies listed on the New York Stock Exchange, American Stock Exchange or Nasdaq markets have a single shareholder who could satisfy the five percent ownership requirement.³⁰⁰

The Proposed Rule's high threshold presumes that institutional shareholders are not only willing to monitor the board and the individual board members' performance, but that the institutions will become activists when appropriate. However, they are usually not activists and instead focus their fund manager's time on evaluating a company's financial performance and have no expertise in evaluating individual directors. An activist role would also require them to invest their internal resources on this additional (altruistic) activity, and there is no evidence they would be willing to do so, when all shareholders would reap the benefit. Not only do institutional holders typically subscribe to the "Wall Street Rule" of selling if they are unsatisfied with a company or board's performance, they may have competing interests with other shareholders, because their particular investment strategy requires a short-term instead of long-term horizon, for example. Relying on large institutional shareholders to oversee this process may not be wise.

The one percent threshold to place a shareholder access proposal on the ballot is too low. This would allow, in essence, "the tail to wag the dog," because only one percent of a company's shareholders would be able to set a costly and time-consuming process in motion.

ommends against proposals to eliminate cumulative voting or proposals that require supermajority voting requirements. ISS Proxy Voting Guidelines Summary, available at http://www.atalantasosnoff.com/2003_U.S._Voting_Guidelines_Summary.pdf (last visited Mar. 25, 2005).

300. See Proposed Rule, *supra* note 7, at 60,794.

Is this fair to the other ninety-nine percent of the shareholders? While a Rule 14a-8 shareholder proposal can be placed on the ballot by any shareholder that owns \$2,000 of stock, those proposals do not have the potentially huge impact that naming one of the small handful of directors who “guide the ship” does. Moreover, they are predominately advisory proposals anyway, so the directors must still consider the overall best interests of the company in deciding whether to implement them.

The thirty-five percent withhold threshold for an individual director is arbitrary and does not follow other corporate governance principals. Corporate law typically operates on a principal of “majority rules,” where in most cases, the deciding criteria is either the majority of the outstanding shares or the majority of the shares voting on a proposal, except in corporate take-overs and similar activities. Here, instead, the rule proposes a new thirty-five percent threshold as an arbitrary number that purportedly signifies “shareholder dissatisfaction.” But this does not seem to be supported by any other area of existing corporate law.

2. Time Period Too Long

If a company is struggling with its board’s lack of response and accountability to its shareholders, instituting a two-step, two-year process before shareholders can act will only exacerbate a bad situation, potentially to the point where it is beyond repair or too late, as in Enron. The last two years of corporate governance scandals described in Part I show that even large companies can undergo rapid changes. And at the end of two years these companies were all but subsumed with problems and share value had disappeared. To truly protect shareholders, any new paradigm must be triggered on short notice when there is a problem indicated.

Also, the Proposed Rule forces shareholders to institute the process to nominate a candidate, in order to preserve their right to do so, long before the shareholder and directors may have had an opportunity to work through any concerns. Rather than encouraging the shareholders and board to first work together for constructive change and amicable resolution, it pits shareholders against the company because of the long fuse required.

F. Disruptive and Will Not Improve the Selection Process

1. Premature and Costly

The new corporate governance regulatory scheme prompted by the Sarbanes-Oxley Act is just now taking effect. We should assess the impact of these new rules, their pros and cons, before piling more rules upon rules without fully understanding their impacts, costs and outcomes. The Proposed Rule addresses the same concerns that the Sarbanes-Oxley Act, the NYSE and Nasdaq Listing Rules, and the Nomination Committee Rule have already addressed: board composition, independence, qualifications of board members, and communication between the board and shareholders. These new rules are likely to encourage diligence and director scrutiny of company business operations and management's actions. Independent directors know their actions are being watched, now more closely than ever before. We need to give these new rules time to show their effectiveness.

Moreover, while the SEC has estimated the cost of the new rule to be \$4,200 per company,³⁰¹ industry experts expect the true cost of the new rule to be in the neighborhood of \$700,000 per company.³⁰² This wide divergence in the estimated cost of the rule signifies a problem with interpreting how this rule would actually be implemented in the market. Companies are just now assessing the costs of the Sarbanes-Oxley Act, and it seems premature to impose additional huge costs when it is not clear that those costs are warranted or will be effective.

2. Will Produce Worse Boards

a. Special Interest Directors

This rule will open the boardroom door to special interest directors—those that advance a narrow cause and/or represent a narrow slice of shareholders. Special interest groups now dominate the Rule 14a-8 arena,³⁰³ and it would likely be that those same groups would

301. See Proposed Rule, *supra* note 7, at 60,814.

302. Letter from Henry A. McKinnell, Chairman of the Business Roundtable, to Jonathan G. Katz, Secretary of the SEC (Dec. 22, 2003), available at <http://www.sec.gov/rules/proposed/s71903/brt122203.htm>.

303. See John C. Wilcox, *The Growing Importance of Institutional Investors and Equity Analysts for the M & A Agenda*, PLI CORP. LAW PRACTICE COURSE, HANDBOOK SERIES NO. B4-7179 (1997), 973 PLI/Corp 567, 574-77 (“The air of legitimacy which attached to institutional activism has been co-opted by other proponents, including labor unions, grassroots organizations, and others traditionally categorized as gadflies . . . who now numerically dominate Rule 14a-8 shareholder proposals,” and the “proxy process has arguably been trivialized

take advantage of this rule, to the detriment of other shareholders who do not share that same special interest.

A nominee that does not share a visible tie with the nominating shareholder (such that the nominee would fail the independence requirements) is not necessarily truly and utterly independent. Common social and business viewpoints and other non-contractual relationships would not be covered by the independence standards. It is only natural that one shareholder (or a group of shareholders) nominating a candidate will act in that particular holder's own self-interest. It is utopian to believe that shareholders voluntarily and altruistically work for the benefit of all.

While the theory of the Proposed Rule is good, history has shown us that good theories do not always work out well in the "real world." In theory, "a small percentage of large, long-term shareholders—with nothing but the best interests of the company and all fellow shareholders in mind—will act in a neutral and unbiased manner to further the corporation's interests by nominating a candidate for the Board who is better than management's nominee."³⁰⁴ However, as SEC Commissioner Glassman pointed out, "Communism works . . . *in theory*."³⁰⁵ History has taught us, and the same applies here to the Proposed Rule: If it sounds too good to be true, it probably is.

b. Less Qualified Candidates

Companies must balance the members of their board to serve specific needs identified by those close to the company. Outside shareholders, even large ones, do not know the inner workings of the boardroom, the specialties each director brings to the board table, and those qualities that may be absent. In addition, as board members come and go, the balance of a board is constantly in flux, and the company must always keep an eye on meeting mandatory governance requirements. Allowing a shareholder to unilaterally nominate one or more directors will potentially upset that balance and long-term board constituency planning.

as special interest groups resume the dominant role sponsoring shareholder proposals.").

304. SEC Commissioner Cynthia A. Glassman, Remarks at the National Association of Corporate Directors (Oct. 20, 2003), available at http://www.sec.gov/news/speech/spch102003cag.htm#P32_10471.

305. *Id.* (quoting cartoon character Homer Simpson).

c. *Dysfunctional and Balkanized Boards*

In order to effectively perform its role, the board should be comprised of members who can work together in a professional environment with a minimum of distraction and disruption. Some level of collegiality must be present for the board members to work together and with management. A candidate who has not been approved by the company's management and other incumbent directors will likely not work well with them and will be viewed instead as a "bull in the china shop."

The Proposed Rule would result in directors with dual loyalties and a divided, "balkanized"³⁰⁶ board. This, in turn, will cause boards to be distracted with internal politics, taking valuable time and energy away from their primary duty to serve the company's shareholders. Moreover, to serve as effective advisors to management, the board members and management must share mutual respect and trust, and a director who has been added to the board without the agreement of management or the other board members will have a difficult time earning that respect and trust.

3. *Lack of Fiduciary Duty*

The board is the only body that truly balances competing interests of the constituents of a corporation—the board, the management, the employees, the shareholders, the stakeholders and the community. While some use a property analogy for stock ownership,³⁰⁷ shareholder rights are actually outlined according to state corporate statutory law and by specific contracts, i.e. the corporation's articles and bylaws. Moreover, agency theory and the accompanying agency problems³⁰⁸ also appear inapplicable to the board setting because the

306. See, e.g., THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (4th ed. 2000), available at <http://education.yahoo.com/reference/dictionary/entry/Balkanize> (Balkanization is derived from "balkanize," which is "to divide (a region or territory) into small, often hostile units."); see also CountryWatch, Balkanization, at <http://www.country-watch.com/@school/balkanization.htm> (last visited Mar. 25, 2005) ("The term generally describes the process of geopolitical fragmentation, and is used to depict any kind of political dissolution across the world."). See generally Radom, *supra* note 65 (arguing for limited federal preemption of state securities regulations as a solution to the problem of balkanization).

307. See generally Lucian Arye Bebchuk, *The Case for Empowering Shareholders*, *Pa-per* 86, BERKELEY PROGRAM IN LAW & ECON., WORKING PAPER SERIES, http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1057&context=berkeley_law_econ (Mar. 1, 2003) (analogizing the shareholders' ownership of a public company to an individual's ownership of "a building in Seattle").

308. See generally Aleta G. Estreicher, *Beyond Agency Costs: Managing the Corporation for the Long Term*, 45 RUTGERS L. REV. 513, 514-15 (1993) (proposing an alternate frame-

board's duty is to act in the best interests of the corporation and not toward any specific individual shareholder.

While shareholders seeking to access the company's proxy statement to promote their director candidate must comply with the anti-fraud provisions of the federal securities laws, there is no corresponding requirement that they owe any fiduciary duty to the corporation or their fellow shareholders in seeking to activate their rights under the Proposed Rule.³⁰⁹ In contrast, the company's management, incumbent directors and members of the nominating committee, who confer to nominate who they believe are the best qualified candidates in the interests of all shareholders, do owe a fiduciary duty, not only in managing the corporate assets, but also in making the nomination. Shareholders will be best protected by having persons that owe that fiduciary duty look out for their interests.

4. *Out of Sync with International Standards*

In other countries, shareholders typically have the authority to appoint and remove directors with "comparative ease," and some argue the Proposed Rule will cause the United States to be "out of sync" with practices in worldwide securities markets.³¹⁰ In the United Kingdom, for example, shareholders may include a resolution to appoint a director at any Annual General Meeting so long as the holder owns a minimum of 100 fully paid shares or, alternatively, their shares represent at least five percent of shares entitled to vote at the meeting.³¹¹ A simple majority is required to pass the resolution, and the election outcome is binding on the company.³¹²

In addition to voting against a director who is standing for reelection, UK shareholders are also allowed to vote against the election

work to reduce agency costs through structuring management incentives for long-term corporate performance, thereby reducing the focus on maximizing short-term shareholder values that is inherent in the recent trend toward managerialism).

309. However, a *controlling* shareholder may have obligations to the other shareholders. See, e.g., *Riblet Prods. Corp. v. Nagy*, 683 A.2d 37, 40 (Del. 1996) (noting that majority shareholders may owe fiduciary duties to minority shareholders); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987) (noting that a shareholder owes a fiduciary duty to other shareholders if it "owns majority interest in or exercises control over the business affairs of the corporation") (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985) and *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984)).

310. See Letter from Jean M.G. Frijns et al. to Jonathan Katz, Secretary of the SEC (Dec. 19, 2003), <http://www.sec.gov/rules/proposed/s71903/foreign121903.htm>. The twelve signatories to this letter represent a group of large foreign institutional shareholders whose members hold \$722 billion in assets. *Id.*

311. *Id.*

312. *Id.*

of a director at the meeting that follows his/her original appointment.³¹³ Again, a simple majority is required, and the outcome is binding on the company.³¹⁴ Shareholders who hold shares representing ten percent or more of voting capital of a company are entitled to call an Extraordinary General Meeting, at which they can include resolutions to appoint and/or remove directors.³¹⁵ These also require a simple majority and are binding.³¹⁶

Similar rules apply for the director nomination and election processes in Australia, France, Germany, India, Ireland, New Zealand, South Africa, Sweden and other countries who have modeled their statutes on UK company law.³¹⁷

G. Back to Basics—Let's Play Fair

1. Common Goal

Companies and their shareholders share a common goal to create a healthy economy through long-term business operations and successful competition in the world economy. This should not be based on intrinsic shareholder rights being exercised in a hostile environment, but should instead be based on social and economic utility. Shareholders and managers should work cooperatively toward business success, rather than shareholders dictating managerial conduct based on their intrinsic rights and individual interests. A paradigm that instead promotes a serious, collaborative and constructive dialogue between shareholders and the company's board of directors would be more efficient than one that creates hostilities and dichotomy.

Through corporate America's newly-adopted regulatory scheme of corporate governance, on which the "ink is still wet," shareholders and directors can work together toward these goals. We only need to give them time to be effective. We have the right tools; we should encourage rather than discourage their use.

313. *Id.*

314. *Id.*

315. *Id.*

316. *Id.*

317. *Id.*

2. *Use the Right Tool—Nominating Committees*

The Proposed Rule presumes that nominating committees, even as re-constituted under newly-adopted regulations, will not be effective at responding to shareholder concerns. But this is an unfair assumption, because those committees have not even had a chance to operate under the new paradigm. This leads one to wonder why we spent the better part of the last two years adopting regulations that very specifically created independence in boards and their committees and transparency in their operations, if we did not believe these were the answers to protecting shareholders.

Rather than making a company's nominating committee a "lame duck," which the Proposed Rule would in essence do, the aim should be to ensure its effectiveness. Shareholders should not be encouraged to circumvent the company's board and its nominating committee. Instead, we want the committee members to listen and be held accountable to the company's shareholders.

Through the Sarbanes-Oxley Act and the NYSE and Nasdaq Listing Rules, regulations are now in place to ensure that the nominating committee members are independent. Central to our system of corporate governance is the notion that independent directors are indeed able to represent the best interests of shareholders, and independent directors are accountable to the shareholders. Following that same notion then, those independent nominating committee members can be charged with the same responsibilities of listening, protecting and being held accountable to the shareholders.

The new Nominating Committee Rule ensures that not only are the operations of the committee transparent and understandable to shareholders, but also that the shareholders will have the information they need to give relevant input to the committee, which will garner the committee's attention. And while technically only requiring disclosure of the communication system a company has in place between its shareholders and individual board members, it seems this disclosure requirement will cause virtually all companies to adopt such a system, if it did not previously exist. This new framework of independence and information is poised to serve the goal of ensuring that the nominating committee is responsive to shareholder concerns.

Selecting individual directors is a key component to a company's success, both in creating value and in protecting that value for all shareholders. It should come at the consensus of the many constituents, not at the direction of a powerful one or few. The committee members who are inside the boardroom are the ones best positioned to

determine the needs of the company, not outside shareholders, who may have a hidden agenda. Shareholders should indeed participate in the director selection process, but by working closely with the appointed nominating committee, rather than stepping into the arena of managing the internal affairs of a company, which is a role reserved for those with expertise and fiduciary duties.

Increased shareholder input into the nominating committee process, by ensuring the committee members are independent and the operations are transparent, will provide the benefits the Proposed Rule attempts to gain. Moreover, encouraging use of truly independent and transparent nominating committees does not have the unintended negative consequences associated with the Proposed Rule. With the increased attention the Proposed Rule has now brought on the topic, we should give these newly formulated committees an opportunity to prove whether we have sufficiently regulated this area, before we cross the line into over-regulating it.

CONCLUSION

Corporate scandals have caused the investing community and regulatory agencies to take a second look at those who would be “captain of the ship.” Shareholders understandably want a board they can put their full trust in, and the recent scandals have caused many investors to rightfully question those at the top. While more shareholder voice in the director nomination process is in theory a good thing, the SEC’s proposed shareholder direct access rule will not prove an effective method of electing a board of directors who can and will protect and create value for all shareholders. Not only is the rule based on questionable legal authority, but it also lacks tools to be truly effective. Instead of piling rules upon rules, the new regulatory scheme, provided by the recently-enacted Sarbanes-Oxley Act, the NYSE and Nasdaq Listing Rules, and the Nominating Committee Rule, provides the necessary independence, additional transparency, and increased shareholder voice in the nominating process. Shareholders and directors can work together toward their common goals under the newly created paradigm. If, however, time tells us the system is still “broken,” then, and only then, should the SEC move to “fix it.” For now, the shareholder direct access rule is simply overkill and will upset the fine teeter-totter balance between shareholder voice and investor protection.

