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**ADVICE AND CONSENT:**  
**AN ALTERNATIVE MECHANISM FOR SHAREHOLDER PARTICIPATION**  
**IN THE NOMINATION AND ELECTION OF CORPORATE DIRECTORS**

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INTRODUCTION

The principle of comparative advantage is central to modern economic analysis. It suggests that societies benefit greatly when they are organized to promote functional specialization. The same principles of comparative advantage and functional specialization are expressed in electoral systems. Indeed, one of the many reasons to prefer representative democracy to direct democracy is that representative democracy allows for the evolution of a “governing class” that specializes in forms of decision-making necessary for the intelligent exercise of governmental authority.

A key tension in the design of any system of representational government arises from the need to craft a mechanism that balances the power entrusted to the governing class against the danger that the governing class will usurp that power in order to advance its self-interest over the interests of constituencies they are charged to represent. There is no generally accepted solution to this vexatious problem either in the political sphere or in the corporate realm, where it is often described as a form of an “agency problem.”

Richard Posner’s most recent book, *Law, Pragmatism and Democracy*,<sup>1</sup> masterfully describes these tensions in the political realm. Posner sets forth an intriguing if incomplete argument for a Schumpeterian form of competition among collectives of representatives, experts, or elites. It envisions a pragmatic form of democracy described as a method of competition among teams subject to complex webs of checks and balances that are designed to assure fidelity to the electorate.<sup>2</sup>

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Posner's description of the United States' constitutional structure and its historical evolution is intriguing and quite relevant to the question of shareholder access to the corporate ballot:

The founding fathers, Posner says, did not want to set up a democracy but a mixed government. That is in fact what they created — with monarchical elements in the presidency, aristocratic elements in the Senate and Supreme Court, and democratic elements in the lower house. The whole thing was intended to be a balance of interests in a way Cicero said a successful republic must be.<sup>3</sup>

It also follows that:

once you have agreed that government is a job for the full-time expert and that “rule by the people” is literally impossible, you need some way in which the ordinary man can stop the elite from walking off with the store. The London mobs used to smash the windows of the rich; universal suffrage serves the same purpose with less damage.<sup>4</sup>

The system of mixed government with its complex web of checks and balances described in the United States Constitution contains a provision that can be emulated to great benefit in the current debate over shareholder access to the ballot. Article II Section 2 of the Constitution defines a mechanism for “advice and consent” between the Executive Branch and the Senate that, as a practical matter, preserves for the Executive the initiative in selecting the members of his own administration, but forces compromise with the Senate in the event that a particular candidate cannot garner support of a majority of that body. As applied to the operation of the Executive Branch, this mechanism has great merit as an expression of the principle of comparative advantage. The Executive is far better able than the Legislature to determine the identity of appointees who will be able to carry out the Executive's agenda.<sup>5</sup> The fact that the Executive was duly elected does not, however, give him *carte blanche* to fill the government with every crony he prefers. The need to attain the consent of a majority of the Senate provides a safeguard against that outcome, while still respecting the Executive's rational prerogative, rooted in the principle of comparative advantage, to work with a team of his choosing. Thus, the Senate can never

formally select a Secretary of State or a member of the SEC, but a majority of the Senate can, as a practical matter, force a wide range of compromises on Presidential nominations through the exercise of the veto embedded in the “advice and consent” mechanism.<sup>6</sup>

Instead of emulating this Constitutional model of advice and consent, the United States Securities and Exchange Commission has proposed to enhance shareholders’ ability to nominate directors on the corporation’s own proxy through a two-stage electoral process. This two-stage process is, however, quite complex and time consuming. It also threatens unnecessarily to provoke confrontation between shareholders and incumbent boards, rather than to promote cooperation between those two constituencies in search of more effective corporate governance.

Therefore, even if one is persuaded that corporate governance can be improved in a cost-effective manner by providing shareholders with greater voice in the process of nominating and electing directors, it does not follow that the mechanism proposed by the Commission is the most appropriate technique for achieving the desired objective. Further, because the Commission could dramatically alter its proposed shareholder access rules to emulate the Constitution’s advice and consent procedure, and thereby eliminate or reduce much of the criticism that surrounds its current proposal, the possibility arises that the Commission could assuage at least some of the major concerns voiced by the rule’s many opponents if it proposed a different process in pursuit of the same objective.

The first portion of this paper describes the Commission’s new rule proposal and summarizes the major arguments propounded by the rule’s proponents and opponents. This portion also observes that there is much we do not know about the operation of corporate governance, and that neither proponents nor opponents can muster empirical data in support of their views. For that reason, the analysis also suggests that the Commission should undertake further fact-finding before adopting any rule, and that any rule adopted in this area be subject to an automatic sunset provision that will force careful re-evaluation by the Commission while promoting more responsible conduct by shareholders and incumbent boards alike.

The second portion describes the operation of an alternative mechanism that draws heavily from the Constitutional model of “advice and consent,” and that incorporates the notion of comparative advantage. The third portion describes evidence that shareholders have a comparative advantage in the identification of suboptimal governance structures, but that incumbents may have

a comparative advantage in the resolution of identified deficiencies, once the incumbents concede that the deficiencies should be addressed. The fourth portion describes the advantages of an advice and consent procedure over the Commission's direct access proposals. The fifth portion describes some of the disadvantages of the advice and consent procedure, recognizing that there are no perfect solutions to the problems presented in any governance debate. The sixth portion offers brief concluding observations.

### THE COMMISSION'S PROPOSAL

On October 8, 2003, the Commission proposed that all registrants subject to the proxy rules also be required to provide certain shareholders with direct access to the corporations' proxy so that those shareholders could nominate at least one and up to three directors, depending on the size of the company's board, to run in opposition to the incumbent's proposed slate, if certain triggering conditions are satisfied.<sup>7</sup> Shareholders eligible to nominate directors must demonstrate that they have beneficially held at least 5% of the company's voting equity securities continuously for at least two years, and that they have filed beneficial ownership reports on Schedule 13G.<sup>8</sup> If the number of shareholder nominees exceeds the maximum stipulated by the proposed rule, then the nominees to be included are those supported by the shareholders representing the largest number of voting shares.<sup>9</sup>

The shareholder right to nominate directors is triggered if:

(a) more than 35% of the votes cast at a meeting to elect directors are marked to withhold authority for the election of at least one of the registrant's nominees for the board of directors;<sup>10</sup> or

(b) shareholders who have held at least one percent of the registrant's voting securities for at least a year submit a shareholder proposal, pursuant to Rule 14a-8, that the shareholder nomination provision of Rule 14a-11 be triggered, and that proposal receives the affirmative support of more than fifty percent of the votes cast on that proposal.<sup>11</sup>

Any shareholder's ability to participate in this process is conditioned on the requirement that "applicable state law does not prohibit the registrant's security holders from nominating a candidate or candidates for election as a

director.”<sup>12</sup> The Proposed Rule is neither temporary nor subject to an automatic sunset provision.

### *The Debate Over the Commission’s Proposal*

The Proposed Rules have stimulated a sharp debate. “Business leaders [say] the rules go too far, while investors say the rules don’t go far enough.”<sup>13</sup>

Without seeking to be encyclopedic, the Proposed Rule’s opponents predict that the rules will generate no end of mischief if adopted, and assert that they do not constitute a reasoned response to the Commission’s legitimate concerns over the effectiveness of corporate governance. In particular, consternation is voiced that shareholders will have an incentive to use the rules to promote special interest candidates who, if elected, will prove to be divisive board members. There is a fear that competent directors would decline the opportunity to serve on a board if they had to participate in direct electoral combat. Questions are raised about shareholders’ ability to identify dysfunctional boards and to nominate suitable directors. More fundamentally, the observation is made that the corporate governance process has just been revolutionized by Sarbanes-Oxley, and that Sarbanes-Oxley procedures should be allowed to become operational for a period of years before deciding whether the additional measure of direct shareholder access is either necessary or appropriate.<sup>14</sup>

From a mechanical perspective, the Rule’s opponents observe that the 35 percent threshold for shares marked to withhold authority to elect a director is too low, and suggest that a 50 percent threshold is more reasonable.<sup>15</sup> Similarly, the suggestion is made that the thresholds associated with the shareholder initiative mechanisms are too low, that the criteria for nominating directors are too liberal, and that the costs likely to be imposed are too great in comparison with benefits that are too remote and speculative.

The Proposed Rule’s proponents view these concerns as dramatically overblown. They reason that a majority of shareholders have no incentive to support board nominees who would cause a reduction in shareholder wealth. Concerns that special interest candidates will lead to divisive boards are therefore exaggerated. Proponents also contend that directors who are unwilling to engage in a debate over their fitness to serve should not serve on boards. They observe that Sarbanes-Oxley does nothing to increase director responsiveness to shareholder concerns, and in light of governance failures at Enron, WorldCom and other entities, direct shareholder access as envisioned by the Proposed Rules are, if anything, a too-tentative step in a necessary direction.<sup>16</sup>

From a mechanical perspective, the rule's proponents complain that the two-stage process is too long and costly. To mount a challenge under the Proposed Rules, shareholders will have to persevere in their campaign for two years or more. Proponents also complain that trigger shareholder thresholds are too high, that holding periods are too long, and that the numbers of directors who can be nominated are too low.

### *How Will the Proposed Rules Be Applied in Practice?*

As just described, the literature is rife with speculation over how the Proposed Rules will be applied in practice. Some observers express an almost apocalyptic concern that proxies will become littered with special interest candidates who, if elected, will factionalize boards and cause boards to degenerate into dysfunctional entities. Other observers adopt an almost Panglossian view that because a majority of shareholders can be relied upon not to engage in actions that would harm the enterprise, there is no meaningful cause for concern over the adoption of the Proposed Rules.

The reality is that we do not know how these rules will work and whether they will generate benefits in excess of their costs. There are no meaningful empirical data that allow us to project the likely costs and benefits of the proposed rule for the simple reason that no mechanism even remotely resembling the Commission's proposal has ever been implemented. Efforts to extrapolate from the existing literature are therefore easily criticized because existing findings have to be stretched far beyond their initial application to draw even the most remote inferences about the likely implications of the Proposed Rules. It therefore seems prudent to engage in further information gathering activities before deciding whether to adopt or modify the Proposed Rules.

Significantly, the institutional investor community has been largely silent as to how it might seek to take advantage of the Proposed Rules if they are adopted. The Commission and commenters alike are therefore forced to engage in significant speculation regarding the application of the Proposed Rules. This gap in our understanding is not entirely necessary and could be resolved in part if the investor community would provide detailed responses to the following questions:

First, is it possible to identify specific directors at specific companies whom investors would like to have removed from their current board seats? Who are these directors? At which companies do they serve?

Second, why would investors want to remove these specific directors from

their seats? Which objective criteria, if any, would be applied to reach these decisions?

Third, with whom would the investors want to replace the ousted directors? Why would investors prefer these alternative candidates? Identifying specific replacements would again be useful in order to make the nature of the controversy concrete.

Fourth, on what basis would investors believe that the newly constituted board would, as an entity, be superior to the prior board?

It bears emphasis, however, that even if investors provide cogent responses to each of these questions, there can be no assurance that the future will in fact even remotely resemble the promise of the future that would be described in these responses. Indeed, investors have every incentive to provide only the most high-minded examples of situations in which they would seek to replace directors. They would have little incentive to describe situations in which they would be nominating special interest directors with agendas that diverge from traditional shareholder interests, or directors who would likely be viewed as overtly disruptive to the operation of a corporation's board.

Responses to these questions should therefore not be viewed as unbiased predictors of the likely application of the Proposed Rule. Instead, these responses should be viewed as "best case" projections, and should be interpreted with appropriate caution precisely because of the predictable bias inherent in the responses.

### *A Mandatory Sunset Provision*

Given the current state of the record, if the Commission determines to proceed with rulemaking in this area, then there are at least two distinct reasons to make any adopted rule subject to a mandatory sunset provision that will cause the rule to lapse after say, five years, unless there is an affirmative finding by the Commission to extend the rule's operation.

The first relates to our lack of data regarding the governance implications of any rulemaking in this area. Experience teaches that regulations are subject to a variant of Newton's First Law of Mechanics, also known as the Law of Inertia: A regulation, once adopted, stays adopted, even if its costs exceed its benefits, unless it is acted upon by a sufficiently powerful political force — which is a rare event indeed. Accordingly, if the Commission is serious about getting the rule "right," a simple commitment to cause the staff to study the rule and to report on the rule's operation in a period of years is unlikely to be a suf-

ficiently powerful incentive for profound reconsideration in light of important new experience.

The second reason is more instrumental. If shareholders and directors alike are aware that the Commission is actively monitoring the operation of the Proposed Rule, and that the Commission is precommitted to reconsidering the rule in depth, then each constituency will have an incentive to be on its best behavior. Shareholders, for example, will have an incentive to avoid mounting campaigns that promote special interest constituencies that are likely to be divisive, lest they prove the rule's opponents correct in their prediction of corporate mischief. Directors will simultaneously have an incentive to be on their best behavior and to work with significant shareholders who have legitimate governance concerns in order to demonstrate that shareholder access rules are not necessary as a means of promoting more responsible governance.

#### A CORPORATE ANALOGUE TO ARTICLE II'S "ADVICE AND CONSENT" MECHANISM

Assume for the moment that the Commission's judgment is correct: greater directorial responsiveness to legitimate shareholder concerns over board composition is entirely appropriate and the proxy rules should be amended to promote this objective. It does not necessarily follow that the complex two-stage electoral process prescribed by the Commission's Proposed Rules is the most effective means of achieving that objective. Indeed, given the strong criticism of the Commission's proposals by supporters and opponents of shareholder activism alike, it makes sense to consider the possibility that there are alternative means of expressing shareholder voice that will garner fewer objections from all competing constituencies. Toward this objective, the Regulatory Flexibility Act directs the Commission to consider "significant alternatives to the Proposed Rule which accomplish the stated objectives of applicable statutes and which minimize any significant economic impact of the Proposed Rule on small entities."<sup>17</sup> The agency therefore has a statutory obligation to consider "significant alternatives" to its proposed rules, and a corporate advice and consent mechanism may well constitute just such a superior significant alternative for large and small entities alike.

In capsule form, the proposed corporate advice and consent mechanism provides that if a director is elected notwithstanding the fact that a majority of the votes cast are marked to withhold authority for that director's election, then a series of disabilities would attach to that director's service at the SRO and/or

SEC levels. The disabilities can be structured so as to provide a strong incentive for any director not to want to serve against the will of the majority of the shareholder base, and for the board not to want any such director to serve. The disabilities could be structured to take effect with a lag, and “cure” mechanisms could also be designed in order to provide an effective opportunity for compromise negotiations among shareholders and incumbent directors. Thus, if the mechanism operates as envisioned, an incumbent board would always retain the initiative in identifying potential new directors, just as the Executive retains that initiative under Article II, but the shareholder base can by majority vote effectively impede or block service by any nominee, similar to the right granted to the Senate under Article II. The competing constituencies would therefore have an incentive to negotiate toward compromise candidates who are acceptable to each constituency, just as the Executive and the Senate are forced to compromise in the case of a dispute over a Presidential nominee who requires the advice and consent of the Senate.

This section expands on the potential operation of an advice and consent mechanism by first describing certain attributes of state corporation law that permit directors to serve over the objection of a majority of shareholders. It then describes specific disabilities that can attach at the SRO and SEC levels to service by such directors, and explains how delayed effective dates for these disabilities together with “cure” mechanisms can help force compromise among incumbent directors and objecting shareholders. This section concludes with observations regarding situations that can arise if the parties fail to reach a compromise.

### *The Election of Directors Notwithstanding Majority Shareholder Opposition*

“SEC regulations in effect since 1967 require that the “form of proxy which provides for the election of directors . . . provide . . . means for security holders to withhold authority to vote for each nominee” even when the nominee stands unopposed for election.”<sup>18</sup> A decision to withhold authority to vote for a nominee on the corporation’s own slate “has no legally binding effect. . . . Under Delaware law, if a quorum is present at the shareholder’s meeting then shareholders elect directors with only a plurality of the votes of the shares present in person or represented by a proxy at the meeting and entitled to vote on the election of directors.”<sup>19</sup> A majority is not necessary. “A proxy marked to withhold authority from an incumbent counts for purposes of determining a quorum

but does not count against the nominee. Therefore, even if the overwhelming majority of shareholders withhold authority from management's unopposed slate, those unopposed nominees will still successfully gain a plurality of the votes cast as long as a small minority of shareholders supports management's nominees.<sup>20</sup>

The central point that bears emphasis for present purposes is that state law is not alone in its indifference to the opposition of a majority of shareholders as expressed by a decision to withhold authority for election of a director in an uncontested election. SEC and SRO rules are also indifferent to that fact. Thus, under SEC and SRO rules, a director is fully respected as a director even if 99.9% of the shares are marked to withhold authority for that director's election, and the only votes cast in favor of that director's election are cast by the incumbent board itself. This need not be.

*SRO and SEC Disabilities That Can Be Imposed Upon Service by Directors Elected Notwithstanding a Majority of Votes Being Withheld*

The SEC and SROs have full authority to take into account the fact that a director has been duly elected pursuant to state law notwithstanding the opposition of a majority of shareholders. No provision of federal law requires that such directors be treated at the SEC or SRO levels with a dignity equal to that afforded directors who have majority support from the corporation's shareholder base. Accordingly, the SEC and the SROs can impose a variety of disabilities on directors elected without the support of a majority of the shareholder base.

SRO listing standards could, for example, be amended to exclude from the definition of "independent director" any director as to whom a majority of votes are withheld. Listing standard could also be amended to provide that no director elected over the opposition of the majority of the shareholder base shall have his or her vote counted for any purpose that is required pursuant to a listing standard. Such directors would thus have their votes "sterilized" and would become non-entities for purposes of all SRO rules and regulations.

Federal securities laws also make several references to the role of "director."<sup>21</sup> For example, "at least a majority of the board of directors or persons performing similar functions" must sign registration statements and periodic disclosure filings.<sup>22</sup> Certain disclosures must also be made in registration statements with regard to the Commission's view that indemnification of directors can raise public policy concerns under federal securities laws.<sup>23</sup>

The Commission could readily amend its rules so as to exclude from the

calculation of “majority of the board of directors” for purposes of certain filing requirements all directors serving over the objection of a majority of shareholders. Those rules could also be written so as to continue to hold those directors liable for any misrepresentations or omissions in those filings. The directors at issue would thus also be “sterilized” from participation in filing decisions while remaining exposed to liability.

The Commission could, in addition, amend its policy with regard to the indemnification of directors elected over the objection of a majority of the shareholder base, and commit to litigate the validity under federal securities laws of any indemnification agreement with such a director. Further, although Commission rules currently state that there are no policy concerns related to insurance of directors with regard to securities liabilities,<sup>24</sup> the Commission could amend its view as to this matter in the case of directors serving over the objection of a majority of shareholders.

More aggressively, the commission could adopt the position that insurance and/or indemnification against federal securities law liabilities of a director elected notwithstanding a majority of votes withheld is against public policy and require that all registrants submit undertakings not to provide insurance or indemnification to directors serving under such circumstances.<sup>25</sup> Further, as a matter of internal policy, the Commission could determine to apply greater scrutiny to all '33 and '34 Act filings by registrants whose boards contain directors elected over the objection of a majority of the shareholder base.

The net result of such actions at the SEC and SRO levels would, as a practical matter, cast every director elected over the objection of the majority of the shareholder base as a second class citizen. These rules would also impose burdens on boards and registrants that continue to allow such directors to serve. The more onerous the disability imposed by SEC or SRO rules, the greater the probability that the director will not serve, or that the board will not want the director to serve, and the greater the leverage that shareholders will have in negotiating more acceptable board members or other forms of governance concessions. This paper makes no specific recommendation regarding the appropriate form of disability that should initially attach in the event a director is elected over the objection of a majority of the shareholder base. Reasonable people will differ as to the matter, and my own views are far from firm. Accordingly, I have undertaken to describe rather than recommend potential forms of disability.

Actions of this sort by the SEC and SROs could also influence the behavior of state courts, notwithstanding the fact that, as a formal matter, SEC and SRO

actions do not change state law. Although these observations regarding reactions by state courts are admittedly speculative, it is instructive to observe that no state court has, to the best of my knowledge, ever confronted the question of whether decisions by a director elected with only minority shareholder support should be afforded deference or dignity equal to that provided to decisions by a director elected with majority shareholder support. A court's ability to provide less deference to decisions by such directors would, no doubt, depend on the circumstances in which the question was presented. The distinctions that are already drawn between interested and disinterested directors, as well as between independent and non-independent directors, are potentially illustrative of the distinctions that could evolve even absent action by state legislatures.<sup>26</sup>

#### *Delayed Effective Dates and "Cure" Mechanisms*

In some instances, the immediate imposition of one or more of the disabilities just described could lead to delisting or other adverse consequences that would not necessarily be in the best interests of the corporation or of its shareholders. In addition, it may be in the best interests of shareholders and of the enterprise alike to provide for a period of negotiation during which shareholders and the board can meet and confer as part of an effort to identify appropriate compromise candidates or other governance measures that would suffice to reduce tension between incumbent directors and the majority objecting shareholder base. These objectives can be furthered by adopting delayed effective dates for the imposition of directorial disabilities and by providing for "cure" mechanisms. As a practical matter, it would also be prudent to adopt a provision allowing the Commission and/or the SROs to stay the effective date of any or all disabilities upon a showing of good cause and for whatever period might be determined appropriate by the Commission or SRO.

An effective date provision could provide, for example, that disabilities do not attach to a director's service for a 90-day period following the election. A "cure" period provision could provide that if the board and shareholders can reach an appropriate accommodation then the submission of written consents by shareholders who (a) previously withheld authority for the election of the director, and (b) represent a minimum percentage of votes withheld, and (c) cause the number of shares withheld to now fall short of a majority, would then eliminate all disabilities attached to service by that director. For example, if the

cure period is 90 days (*i.e.*, identical to the effective date delay) and if the minimum cure percentage is 20% of the votes withheld, and if 60% of shareholders withheld authority for the election of Director X, then written consent by at least 12% of the total shareholder base ( $12\% = 20\% \text{ of } 60\%$ ) (provided that these shareholders previously withheld authority) submitted within 90 days of the election would be sufficient to eliminate the disabilities attached to that director because the remaining objecting shareholders would then constitute less than a majority (*i.e.*,  $60\% - 12\% = 48\%$ ). The appropriate percentages for such a mechanism are, of course, not written in stone.

The anticipation is that directors and shareholder will huddle during this cure period to see if they can arrive at some set of satisfactory compromises. One possible set of compromises would have the board adopt a series of governance or other reforms that would be sufficient to assuage shareholder concerns and that would garner a sufficient number of consents to invoke a cure. Another set of compromises would involve the identification of substitute directors acceptable to incumbents and to a critical mass of shareholders alike.

Boards also have the capacity to nominate and elect new directors who may serve for material periods before standing for shareholder vote. The rules could be written so that any director selected by a board to fill a vacancy created by the resignation of a director who was opposed by a majority of shareholders would inherit the same disabilities, unless the same number of shareholder consents could be obtained as would be required to “cure” that director. Such a rule could help avoid potentially objectionable evasive strategies that could be employed by recalcitrant boards. The net effect of these rules would therefore be to provide strong incentives for compromise between shareholders and incumbent directors over appropriate board composition and governance structures.

### *The Failure to Find Compromise*

There is, of course, no guarantee that a board and objecting shareholders will be able to fashion a workable compromise. What then?

The failure to reach a compromise could well serve as an advertisement that a board has lost shareholder support and that a traditional proxy contest, whether or not coupled with a takeover bid, would have a very high chance of success. Alternatively, the failure to compromise could act as a trigger for direct shareholder access to the ballot as is contemplated by the current Proposed

Rules, but the trigger would then only be pulled after a demonstrated inability to reach a consensus through negotiations in which each party is able to emphasize their respective comparative advantages.

### THE SHAREHOLDERS' COMPARATIVE ADVANTAGE AND THE INCUMBENTS' COMPARATIVE ADVANTAGE

There is good cause to believe that shareholders are better able to identify sub-optimal governance structures than incumbent boards and management, but that incumbent boards and management are better able to resolve those problems once the incumbents agree that the problem is real. The most effective real-world illustrations of this phenomenon are probably to be found in the area of CEO succession. There is broad agreement that deciding when a CEO should be replaced is, perhaps, the most important and difficult job that faces a board of directors. The data suggest that incumbent boards often wait too long to replace a CEO, although there is reason to believe that the problem may not be as serious today as it once was. Experience also indicates that incumbent boards who wait too long to oust a CEO can reach perfectly sound decisions when it comes to finding a replacement, and there is no reason to believe that outside shareholders would have been able to do as good a job. An optimal allocation of responsibility under these circumstances would allow shareholders to exert greater force on boards to cause them to replace certain CEOs more quickly, while allowing boards to continue to retain the responsibility to select the new CEO. The same logic suggests that shareholder would have an advantage in deciding which board members should be replaced, but that incumbents could do a better job of identifying the effective replacements. Recent leadership battles at the NYSE and PCAOB, along with the recent CEO outplacements at Motorola, and older experience at Goodyear, General Motors, IBM, Allied Signal, and Tenneco, all support this underlying thesis.

#### *The NYSE*

Some observers suggest that a critical turning point in the debate over Dick Grasso's future came when large institutional investors expressed the view that Mr. Grasso would have to step down.<sup>27</sup> Significantly, those institutions are not owners of the Exchange. Instead, they are customers who can direct significant order flow and who have a meaningful ability to sway public opinion.

The institutions and other outsiders, however, played no discernable role in

the decision to identify John Reed as interim head of the NYSE, and press reports suggest that Mr. Reed was the first choice of the Board committee charged with the responsibility to find a replacement.<sup>28</sup> The decision to select Mr. Reed appears to be broadly supported by the SEC, institutional investors, and other outside observers, and it is valuable to observe that there is no discernable criticism suggesting that a specific alternative candidate would have been a better choice. Accordingly, there is little reason to believe that institutional investors, or other outsiders, would have been able to identify and attract a candidate superior to Mr. Reed as an interim Chairman.

This pattern of events is quite consistent with the hypothesis underlying the “advice and consent” proposal. Outsiders with appropriate incentive structures, such as institutional investors, can be effective in forcefully identifying problems, but incumbents can be more effective in resolving those problems — if they are committed to finding a resolution.

### *The Battle Over Chair of the PCAOB*

The battle over leadership of the PCAOB follows a similar pattern. Some institutional investors and others supported John Biggs for the position. For a variety of reasons, Mr. Biggs was not acceptable to some key decision-makers. Judge William Webster was suggested as an alternative, but his supporters soon discovered that he was subject to disabilities that prevented him from credibly serving as head of the PCAOB. Institutional shareholders were again particularly vocal in voicing opposition. Ultimately, the Commission selected William McDonogh to head the PCAOB. That decision has been broadly hailed as an excellent choice.

This sequence of events again underscores the potential merit of a process that emphasizes advice and consent. Institutions and other critics may have been quite correct that Mr. Webster wasn’t the right man for the job. It does not, however, follow that their preferred candidate, Mr. Biggs, was the only logical alternative, notwithstanding the fact that he may have been eminently qualified for the post. Again, the principle of comparative advantage suggests that institutional voice might work best when it focuses on the identification of problems and leaves to others the task of prudently identifying a solution.

### *Other CEO Replacements*

More recently, Chris Galvin’s September 19, 2003, resignation as CEO of

Motorola was correlated with a 9% increase in the price of the company's common stock. That market response corresponds to an approximate \$2.6 billion increase in shareholder value. No successor had then been named. However, the market's response suggests confidence in the board's ability to select a competent new CEO because if the market expected that the new CEO would perform only as well as the recently ousted CEO, then there would have been no reason for Motorola's share price to increase upon Galvin's ouster. Shareholders have been suggesting for quite a while that management changes at Motorola were called for, and the pattern of events to this point suggests another example of a board that has been too slow to respond but that can probably be relied upon to identify an effective replacement once it becomes committed to change.

Ten years ago I suggested that significant shareholder value could be created if boards, listening to the responsible concerns of large shareholders who have no agenda other than the preservation of the value of their investments, moved more rapidly to replace underperforming CEOs.<sup>29</sup> That study indicated that CEO replacement decisions at Goodyear, Allied Signal, Tenneco, and General Motors, increased shareholder value by 11.6%, 12.5%, 14.7% and 6.1%, respectively. At early 1990's equity values, which are much lower than current values, those CEO replacements added \$2.7 billion in market capitalization. Subsequent instances of CEO replacements at IBM and at many other major corporations reinforce this basic trend, and are consistent with the comparative advantage hypothesis upon which this advice and consent proposal is based.

#### ADVANTAGES OF THE PROPOSED "ADVICE AND CONSENT" MODEL

An "advice and consent" model of shareholder participation as described in this paper has at least seven identifiable advantages over the Commission's shareholder access proposal. In particular:

An advice and consent mechanism dramatically reduces the probability that the electoral process can be "hijacked" by a group of shareholders who seek to promote a special-interest agenda through the candidacy of a specific director. Shareholders will be able to challenge the inadequacies of sitting boards and will be able to force significant compromises, but it will be difficult for a small group of investors to use the "advice and consent" mechanism to advocate a special-interest agenda.

The advice and consent mechanism dramatically reduces the probability that successful participation by shareholders in the governance process will lead to the creation of divisive boards that have difficulty in functioning well as a team. The objective of the “advice and consent” mechanism is to force a workable compromise between an incumbent board and a disaffected shareholder majority. As suggested above, if no such compromise is reached, the incumbent board then becomes an easy target for a traditional proxy contest.

“Advice and consent” eliminates the need for the Commission to define the category of investors who are “qualified” to propose nominees for the corporate ballot. Any such definition is essentially arbitrary and highly judgmental, and is open to reasonable criticism from shareholder advocates as having been set “too high” or reasonable criticism from defenders of the status quo as having been set “too low.” The agency will not be able to present any data that can objectively support any conclusion it might reach with regard to setting thresholds for “qualification.” The proposed advice and consent mechanism is, instead, more democratic and egalitarian because it treats all shareholders equally with regard to their right to express disapproval by withholding authority to elect any specific director.

“Advice and consent” eliminates the need for the Commission to define a “triggering event” that would serve as a necessary pre-condition to shareholder access. Again, critics from all sides will be able to attack any definition proposed by the Commission as arbitrary and as being either too liberal or conservative. Again, the agency will be able to present no data upon which it would be able objectively to support any decisions it might reach.

“Advice and consent” eliminates the need to rely upon a two-election cycle in order to force directors to face concerns voiced by a majority of shareholders. As previously explained, if shareholders object to a board’s conduct and wish to avail themselves of the Commission’s direct shareholder process they first have to wait up to a year to try to win an election causing a trigger to be pulled, and then they wait a year to try to win an election causing their candidates to be placed on the board. In contrast, the “advice and consent proposal” provides an effective method for expressing shareholder voice at each election, and without delay. Because the fortunes of corporations and boards can change greatly over any two year span, any reasonable process that can operate in a more timely manner should be preferred to a process that requires shareholders to hunker down for a two year battle that they may or may not win.

The Commission’s Proposed Rules apply only if “applicable state law does not prohibit the registrant’s security holders from nominating a candidate for

election as a director.”<sup>30</sup> This formulation should work to avoid a conflict between substantive state law as protected by the internal affairs doctrine, and disclosure and proxy requirements that are legitimately within the Commission’s purview. This formulation does not, however, work to assure consistency in the application of the Commission’s Proposed Rules. Observe that if some state’s laws are interpreted to prohibit security-holder nominations, or interpreted to allow corporations to adopt charter or by-law provisions that prohibit security holders from nominating candidates for election as directors, then the Commission’s Proposed Rules will be inoperative as to registrants chartered in those states. The Commission’s Proposed Rules would then not be nationally uniform. In contrast, because the advice and consent procedure imposes disabilities at the federal and SRO levels that are wholly independent of state law, the advice and consent procedure will always articulate a uniform, nationwide standard.

“Advice and consent” reduces coordination costs among disaffected shareholders. Under the Commission’s shareholder access model, shareholders would first have to agree that specific directors should be replaced and then further have to identify and agree upon appropriate replacement candidates who would be willing to enter into a potential bare-knuckles political campaign in which the candidate’s background will be scrutinized by private investigators and any foibles or weaknesses trumpeted in full page ads in the Wall Street Journal or New York Times. Because it will be easier for shareholders to identify a problem than to agree on a solution, successfully navigating this second step of the process greatly increases the coordination costs of shareholder action. For that reason, responsible shareholders may well prefer a model in which they can, *de facto*, force the restructuring of underperforming boards without having to assume the potentially difficult challenge of identifying and promoting a named alternative. Put another way, it will likely be far easier for a majority of shareholders to agree that a particular director or set of directors should be forced out than to develop equivalent agreement over the most appropriate replacements.

#### DISADVANTAGES OF THE PROPOSED ADVICE AND CONSENT MODEL.

There are no perfect solutions to the problems that the Commission seeks to address through its shareholder access proposal. The “advice and consent” mechanism described in this paper has its own obvious flaws and limitations.

Readers with a fresh pair of eyes and experience broader than my own will no doubt be able to expand upon the following list of four shortcomings that I perceive in my own proposal:

“Special interest” agendas can have very broad and legitimate social support notwithstanding the fact that they are motivated primarily by concerns that have little to do with the profitability or governance of the enterprise. For example, the anti-apartheid movement relied on the Sullivan principles and shareholder initiatives to build support in the business community. The ability directly to nominate individual dissident candidates to a board who would aggressively promote an anti-apartheid agenda could certainly be viewed as a valuable tool by shareholder constituencies who seek to change social norms. The “advice and consent” mechanism proposed herein would be a weaker tool in pursuit of these objectives because it would not provide shareholders with the ability to rally around a strong, affirmative voice for an express point of view. To the extent that society benefits from the ability to present stark, confrontational choices in the sphere of corporate governance, the more accommodating, compromising approach inherent in an “advice and consent” mechanism might not be preferred.

Notwithstanding the observation that outside shareholders generally do not have a comparative advantage in resolving the problems they have identified, there may well be situations where their preferred candidate is strictly superior to any compromise acceptable to the incumbent board. An “advice and consent” model is less likely to allow shareholders to prevail in those situations.

There is no guarantee under the proposed “advice and consent” mechanism that shareholders and management will reach a consensus notwithstanding the disabling consequences that follow from the decision of a majority of shareholders to withhold authority for a director’s election. Further, even though such a board would likely be a sitting duck for a traditional proxy fight, there is no guarantee that such a proxy fight would result, or that insurgents would be successful in their efforts to unseat a board. The “advice and consent” mechanism might therefore fail to generate meaningful change in circumstances where the Commission’s Proposed Rules would be far more effective.

The cure mechanism would allow a board to remove the disabilities created by a majority withhold vote campaign by negotiating with a subset of the objecting shareholders. A concern therefore arises that the incumbent board can erase the adverse consequences of the withheld votes by making the smallest possible concessions necessary to peel off the least committed

objectors, or by cutting some sort of a special interest deal with a segment of the objecting constituency. These concerns are reduced if one increases the percentage of previously objecting votes that must be “reversed” in order to cure the disabilities applied by the rule. More fundamentally, however, the ability to “cut a deal” with a pivotal block of voters is universal in all democratic processes, and politicians regularly adopt positions that are highly favorable to voters who represent “swing” constituencies necessary for the formation of an electoral majority. The extent to which this aspect of the advice and consent mechanism — which is universal in electoral processes — is a “flaw” or a “feature” is a consideration I leave for each reader to decide.

### CONCLUSION

There is legitimate cause for concern over the state of governance in corporate America. There is, however, no empirical support for the proposition that direct shareholder access to the corporate proxy, as prescribed by the Proposed Rules, can address those concerns in a manner that generates benefits in excess of the Proposed Rule’s costs.

In contrast, a reasoned case can be advanced that an “advice and consent” mechanism modeled on Article II Section 2 of the Constitution is simpler to implement and more likely to achieve the Commission’s stated objective at lower cost. The proposed advice and consent mechanism is also more likely to foster cooperation between shareholders and directors than to provoke confrontation. No doubt, the argument in support of the “advice and consent” mechanism should not be overstated, and even if that mechanism is preferable to the Commission’s complex two-stage election procedure, the possibility exists that it too will fail to satisfy a simple cost-benefit test.

Humility is therefore a meaningful virtue when considering the question of shareholder access. With that virtue in mind, it might be prudent to require that any rule adopted in this area be subject to a mandatory sunset provision and other safeguards designed to control the potential for abuse and to provide incentives for all constituencies to comport themselves in a responsible and prudent manner that furthers the Commission’s objectives of improved corporate governance.

## NOTES

1. Richard A. Posner, *LAW, PRAGMATISM AND DEMOCRACY* (Cambridge: Harvard University Press, 2003).

2. See Alan Ryan, *The Legal Theory of No Legal Theory*, N.Y. TIMES, Sept. 14, 2003, § 7 (Book Review), at 20.

3. *Id.*

4. *Id.*

5. This argument regarding comparative advantage and functional specialization does not apply with equal force to the advice and consent procedure as applied to judicial nominations. Instead, in my view, the power to nominate Article III judges subject to the advice and consent of the Senate is better modeled as one of the perquisites of office that the electorate knows it is granting to the Executive upon election for reasons that are unrelated to the principle of comparative advantage. The power to nominate members of the judiciary, who are supposed to be independent of the Executive and Congress because of the separation of powers doctrine, is thus better understood as a spoil of electoral battle.

6. The advice and consent provision therefore often forces various forms of horse-trading or log-rolling between the Executive and Senate. The Senate might agree to support the President's nominee for Position A if the President agrees to nominate a key Senator's favorite for Position B. The presence of such a strong incentive to compromise is, as explained below, one of the great potential virtues of an advice and consent model as applied to the election of corporate directors.

7. See Proposed Rule: Security Holder Director Nominations, Exchange Act Release No. 48,626, 68 Fed. Reg. 60,784 (Oct. 23, 2003) [hereinafter Proposed Rule].

8. See *id.* at § 14a-11(b).

9. See *id.* at § 14a-11(d)(3).

10. See *id.* at § 14a-11(a)(2)(i).

11. See *id.* at 14a-11(a)(2)(ii).

12. See *id.* at 14a-11(a)(1).

13. Deborah Solomon, *SEC May Boost Holders' Power to Nominate, Elect Directors*, WALL ST. J., Oct. 9, 2003, at C12.

14. See, e.g., Martin Lipton and Steven A. Rosenblum, *Election Contest in the Corporation's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003), which appears as chapter 2 of this book.

15. See Solomon, *supra* note 13 (quoting Commissioner Cynthia Glassman).

16. See, e.g., Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003), which appears as chapter 1 of this book.

17. 5 U.S.C. § 603 (c) (2003).

18. Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 903 (1993) (quoting SEC Rule 14a-4(b)(2), 17 C.F.R. § 240.14a-4(b)(2) (1992)).

19. *Id.* at 904.

20. *Id.* at 904-905 (citing, *inter alia*, DEL. CODE ANN. tit 8, § 141(a) (1991)). *Accord* DIV. OF CORP. FIN., U.S. SEC. & EXCH. COMM'N, STAFF REPORT: REVIEW OF THE

PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS page # of text nn. 19 & 25 (July 15, 2003). *See also N. Fork Bancorp., Inc. v. Toal*, 825 A. 2d 860 (Del. Ch. 2000).

21. Section 3(a)(7) of the Exchange Act defines the term “director” to mean “any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.” 15 U.S.C. § 78c(a)(7) (2003). Rule 405 under the Securities Act provides an identical definition. 17 C.F.R. 230.405 (2004).

22. *See, e.g.*, Form S-3, Signatures, Instruction 1 17 C.F.R. 239.13 (2003); Form 10-K, General Instruction D(2)(a) 17 C.F.R. 249.310 (2003); Regulation S-K, Item 702 17 C.F.R. 239.13 (2003).

23. Regulation S-K, Item 702 17 C.F.R. 229.702 (2003).

24. “Insurance against liabilities arising under the Act . . . will not be considered a bar to acceleration. . . .” Rule 461(c) 17 C.F.R. 230.461(c) (2003).

25. Much in this vein, several courts have recently held that “public policy prohibits payment on an insurance policy for disgorgement or restitutionary measures of damages.” Jonathan C. Dickey and Paul J. Collins, *New Limitations on Insurance Coverage for Penalties*, 17 INSIGHTS 2 (Oct. 2003).

26. Another mechanism for enhancing shareholder voice would look to state legislators to amend state corporation law to attach certain disabilities to, or even prevent, the election of directors over the objection of a majority of shareholders. The focus of this paper is, however, on federal strategies. I therefore put aside for the moment the observation that the states could step forward to take significant action on their own. Such action at the state level would, for a wide variety of reasons, be preferable to intervention at the SEC and SRO levels, but it would require a political initiative much more complex than that required to effect change at the federal level.

27. *See, e.g.*, Vincent Boland, *Institutional Investors Pull the Trigger*, FIN. TIMES, Sept. 20, 2003 at 11.

28. Susanne Craig et. al., *As End Neread, Grasso Held on in Hopes Pay Furor Would Ebb*, WALL ST. J. , Sept. 26, 2003, at A1, Col. 4.

29. Joseph A. Grundfest, *Just Vote No: Strategies for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993).

30. Proposed Rule, *supra* note 7, at § 14a-11(a)(1).