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SHAREHOLDER VOICE AND ITS OPPONENTS

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I. INTRODUCTION

A. Exit and Voice

The concept pair "voice" and "exit" from Prof. Albert O. Hirschman's 1970 volume, Exit, Voice and Loyalty,¹ are standard categories for discussing the options of shareholders confronted with poorly managed stock corporations.² Prof. Hirschman's analysis shows how a participant in a relationship

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¹ Albert O. Hirschman, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970).

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will, if discontent, either voice concerns or exit the relationship. Exit is an "economics" solution, while voice is a "political" solution. The action a participant tends to take is greatly determined by the nature of a given relationship, and voice and exit tend to be inversely related. Where high barriers to exit are combined with free use of voice, such as in a family, the use of voice increases and that of exit decreases. Where free exit is combined with high barriers to the successful use of voice, such as in a relationship between a consumer and the mass producer of a commonly available product, the use of exit increases. Loyalty, such as family ties, patriotism or brand loyalty can countervail the tendency to exit. Voice is generally more expensive than exit, and thus may be used less when interests are split up and diversified, which would require the exercise of voice in a number of different places, but voice has the valuable effect of creating a public good by affecting the environment in which the specific organization operates. Thus, in the case of a shareholder, voice may improve not only her corporation (private good), but the entire market (public good) in which the corporation is active, and while it is possible to exit from a deteriorating corporation, it may not be possible to exit from the market that suffers from such corporation's failure.

In the corporate setting, a shareholder can react to deteriorating performance by using voting rights or litigation to try to change the course of the management (voice) or by selling out (exit). As exit corresponds to sale, its exercise is facilitated through the development of liquid and efficient

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3 HIRSCHMAN, supra note 1, at 15-17.
4 "[T]he decision whether to exit will often be taken in the light of the prospects for the effective use of voice. If customers are sufficiently convinced that voice will be effective, then they may well postpone exit." Id. at 37.
5 Id. at 33.
6 "The availability to consumers of the exit option, and their frequent resort to it, are characteristic of 'normal' (non-perfect) competition, where the firm has competitors but enjoys some latitude as both price-maker and quality-maker – and therefore, in the latter capacity, also as a quality-spoiler. As already mentioned, the exit option is widely held to be uniquely powerful: by inflicting revenue losses on delinquent management." Id. at 21.
7 "[T]he extent to which customer-members are willing to trade off the certainty of exit against the uncertainties of an improvement in the deteriorated product . . . . is clearly related to that special attachment to an organization known as loyalty. . . . As a rule, then, loyalty holds exit at bay and activates voice." Id. at 77-78.
8 Id. at 40.
9 Id. at 101.
10 "If I disagree with an organization, say, a political party, I can resign as a member, but generally I cannot stop being a member of the society in which the objectionable party functions. . . . the individual is at first both producer and consumer of such public goods as party politics . . . he can stop being producer, but cannot stop being consumer." Id. at 102.
securities markets and, for privately held companies, appraisal rights. Exit disciplines management by driving down the company's share price and increasing its cost of raising capital. The message sent by exit is, however, semantically generic; it communicates to the market that something could be wrong, but does not specify what. Exit also provides no guarantee that the new owner of the shares will take measures to correct the original problem, which can augment the public good problem referred to above. This means, from the perspective of a market regulator and the economy as a whole, that use of exit as an exclusive remedy could increase the number of avoidable corporate failures and reduce market efficiency. As voice in this context corresponds to voting or litigation, it is promoted by rules that facilitate the use of communication to defend shareholder rights. A number of such rules have developed over time. The ability to grant proxies, for example, which was forbidden at common law, has become a way of increasing the power of voice by allowing it to be exercised in absentee and, in a proxy contest, focusing it through a single, well-informed channel. This right is augmented by the ability to obtain a copy of the stockholders’ list for the purposes of

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11 See Thompson, supra note 2, at 3-4. Therefore, the enormous undertaking in market regulation performed by the Securities and Exchange Commission, the National Association of Securities Dealers and the New York Stock Exchange, among others, has served to make the exit option more practical for shareholders.

12 It is also true that the sale of stock is less communicative of possible non-public information than is a purchase of stock, for although market participants often are in need of liquidity they are less often under pressure to invest immediately in a particular security. See Steve Thel, $850,000 in Six Minutes—The Mechanics of Securities Manipulation, 79 CORNELL L. REV. 219, 242 (1994), with further citations.


14 Shareholders of corporations generally have rights that have been traditionally been categorized in: "(1) Rights as to control and management; (2) proprietary rights; (3) remedial and ancillary rights." HENRY WINTHROP BALLantine, BALLantine ON CORPORATION 375 (1946). These rights are found in contemporary corporate law statues such as the Delaware General Corporation Law (Del. Code Ann. tit. 8) and the Revised Model Business Corporation Act (RMBCA). The rights as to control and management are mainly voting rights that may be exercised in various circumstances (Del. Code Ann . tit. 8, §§ 212, 211(b), 242(b), 251(c), 271, 275(c); §§ 7.21(a), 7.28, 8.08, 9.21, 9.52, 10.03, 10.20, 11.04, 12.02, 14.02 RMBCA). The proprietary rights are primarily rights to share pro rata in dividend payments (see, e.g., Del. Code Ann. tit. 8, § 151(c); § 6.01(c)(3) RMBCA) and payouts upon liquidation of the corporation (Del. Code Ann. tit. 8, § 151(d); § 6.01(b)(2) RMBCA). The remedial and ancillary rights include the right to bring a derivative suit (Del. Code Ann. tit. 8, § 327; § 7.01 RMBCA) and the right to inspect corporate books and records (Del. Code Ann. tit. 8, § 220; §§ 16.02, 16.04, 16.20 RMBCA). See also ROBERT CHARLES CLARK, CORPORATE LAW 13 (1986); JAMES D. COX, THOMAS LEE HAZEN & F. HODGE O’NEAL, CORPORATIONS § 13.1 (2002), and FRANKLIN A GEVURTZ, CORPORATION LAW 179, 195, 210, 387 (2000).

15 "Corporate practice has come a long way from the common law's nonrecognition of the proxy device. The widespread distribution of corporate securities, with the concomitant separation of ownership and management, puts the entire concept of the stockholder' meeting at the mercy of the proxy instrument. This makes the corporate proxy a tremendous force for good or evil in our economic scheme.” LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION § 6-C-1 (3rd ed., 2004).
running a proxy contest. A recent enhancement of voice has been the creation of organizations that analyze company information and make recommendations to shareholders on the exercise of voting rights, such as Institutional Shareholder Services, Inc. (ISS). This reduces each individual shareholder's cost of analyzing company information and thus reduces the tendency towards so-called rational apathy. Well-known tools for increasing the ability of a shareholder to use judicial action are the shareholder's derivative suit, the class action, and contingency fees. Exit and voice can also be combined. Corporate tender offers present a two-step mechanism in which the shareholders of a target corporation exit by selling their shares to a bidder, who then uses a voice strengthened through the aggregation of the purchased voting rights to replace current management.

B. The Opponents of Shareholder Voice

The governance structure of the stock corporation as it exists under U.S. state statutes displays significant characteristics of a representative democracy. The structure allows capital and expertise to be accumulated in the hands of experienced corporate directors (the representatives), and the right to vote provides not only legitimacy, but also a flexibility that allows the structure to adapt to new circumstances. Like democracy, this structure began its road to modern prominence in the 17th century, and depends to a great extent on the free decisions of numerous individuals to unite in a common cause. Like democracy, shareholder voice is far from perfect, and has opponents who focus...
on the apparent weaknesses of allowing an unregulated mass of relatively unqualified persons determine solutions to oft complex and technical questions. One group of opponents advocates strong, central leadership, and has been called the "managerialists." Another group must de-emphasize the original role of shareholders in corporations so as to meet the needs of their descriptive schema, which sees the corporation as a mediating node, in which the interests of various economic components, or "team" members communally interact efficiently. The managerialists view shareholders essentially as unqualified backseat drivers, and – as the presence of institutional investors on the U.S. market has grown over the decades – have shifted their position from condemning shareholders as inexpert masses, to warning against them as self-interested and short-sighted. The team theorists do not disparage shareholders, but are driven primarily by the telos of their descriptive model; they ask not what the theorist can do to remedy the weakness in shareholder rights, but what the weakness in shareholder rights can do for their theory. Their conclusion is that such weakness is both inevitable and beneficial, for it aids in "insulating corporate directors from the direct command and control of any of the groups that comprise the corporate team." Thus, the managerialists and the team theorists, in presenting respectable and well-intended models are joined by a need to discredit shareholders as the...


As Prof. Melvin Eisenberg points out, "the managerialists . . . would achieve ends of social policy by increasing management power, on the theory that while shareholders are interested only in profits, and client-groups only in their own welfare, management is in a position to balance the claims of all groups dependent on the corporation, including not only client-groups and shareholders, but the general public; in a position, that is, to run the corporation in the public interest." MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 25 (1976). This term has had significantly more currency in its French forms – "dirigiste" and "dirigisme".


Dean Bayless Manning outlines his understanding of the public corporation in 1958: "We have known since 1932 that widespread public holding of shares erodes a chasm between 'ownership' and 'control' and . . . that the faceless mass of small stockholders is increasing by millions. We have known, too, that today's large corporation may for many purposes be best viewed as an intricate, centralized, economic-administrative structure run by professional managers who hire capital from the investor. . . . Here, the buyer of stock does not know even what business the company may be in tomorrow. He is betting on a management, banking on its expert judgement to steer his small investment through the swift currents of today's commercial stream." Bayless Manning, Book Review of J.A. LIVINGSTONE, THE AMERICAN STOCKHOLDER, 67 Yale L.J. 1475, 1489-90 (1958). Messrs Martin Lipton and Steven Rosenblum argue that "]M]any institutional and other activist shareholders have competing interests that may conflict with the best interests of the public corporation and its shareholder body and other constituencies taken as a whole. . . . Some may seek to push the corporation into steps designed to create a short-term pop in the company's share price so that they can turn a quick profit. . . . In addition, investors may have competing interests over and above their financial interests as shareholders. For example, labor unions may use shareholder activism as an element of their collective bargaining strategy or to gain leverage over or access to managers in order to advance union-related objectives." Martin Lipton & Steven A. Rosenblum, Election Contest in the Company's Proxy: An Idea Whose Time Has Not Come, 59 BUS. LAW. 67, 78 (2003).

Blair & Stout, supra note 26, at 255.
sine qua non of the corporation and deny the rights that such primacy implies. The two groups of opponents enlist similar arguments: they argue that shareholders have no inherent right to exercise voice and, even if they did, shareholder influence would still be dangerous because the biases of their class make them unfit to exercise control. Because, in the corporate setting, the right of shareholders to influential voice has been for centuries inherent in their ownership of the corporation,30 opponents of shareholder voice first try to negate shareholder ownership.31 This argument may have gained credence because control is often considered the primary characteristic of ownership, and the position of shareholders under current governance legislation is often one of weakness rather than control.32 The opponents of shareholder voice also attempt to discredit shareholder influence as self-interested and unrestrained.33 Given their positions, it is also understandable that the opponents of shareholder voice have fought fiercely against the visible trend of increasing shareholder voice in recent decades.34

The purpose of this paper is to illustrate that the principal, legal arguments against shareholder voice are unfounded. I find it particularly important to document the existence of shareholders' property rights before they are talked out of existence. This paper does not intend to reiterate the economic grounds that explain why shareholders are the group best suited to control a corporation.35 Rather, Part II will explain the legal nature of the property rights that shareholders have in corporations. Part III will set forth some of the fiduciary and other duties that temper and restrain shareholder behavior in ways very similar to the existing legal checks on management behavior. Part IV will explain how, although shareholders have complete freedom to structure their corporations as they will, the default structure of governance found in U.S. corporations renders shareholders almost completely powerless. Part V will, by way of conclusion, outline how in recent decades the need to facilitate shareholder voice has gradually come into view and prompted real change at the federal level, which – despite strong management opposition – we can expect to continue.

30 “The charter of incorporation of the EIC [East India Company] defined its basic governance structure. This included a Governor, a Deputy Governor, a Committee of 24 – also called the ‘Court of Committees’ (and after 1709, the ‘Court of Directors’) – and a General Court. In fact, the full official name of the EIC (until 1709) was “The Governor and Company of Merchants of London Trading into the East-Indies”. The General Court was composed of all members of the company. Every member, of whatever status and however large a share in the joint stock, had one vote in the General Court.” Harris, supra note 24, at 31.

31 See Part II of this text.

32 See Part IV of this text.

33 See Part III of this text.

34 “Groups such as IRRC [Investor Responsibility Research Center], ISS [Institutional Shareholder Services], and CII [Council of Institutional Investors] track and publish databases of company responses to shareholder proposals. As more companies accede to the demands of shareholder activists, thereby ‘raising the bar’ of what is perceived to be shareholder-friendly behavior, it becomes harder for the remaining companies to resist shareholder pressure when it is applied.” Andrew R. Brownstein & Igor Kirman, Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions, 60 Bus. Law. 23, 66-67 (2004).
II. SHAREHOLDER PROPERTY RIGHTS

Much of the scholarship discussing the weakness of shareholders vis-à-vis management has centered on shareholders being the "owners" of corporations, but has usually not found it necessary to specify exactly what kind of property interests these shareholders have. Opponents of shareholder voice have taken advantage of this to argue that shareholders do not actually have property rights in corporations, are thus not really owners of the corporation, and should therefore not demand to exercise influence as if they were owners. It should be noted that this denial of shareholders' property rights could have been caused not only by the empirical impression received from the weak state of shareholders in contemporary corporations, but also by theories of the firm that have de-emphasized property rights in analyzing the contractual allocation of control within the corporation.

A. Shareholders Own the Corporation, Not Its Assets

In chiding economist Milton Friedman for referring to shareholders as the owners of corporations, Professor Lynn Stout explains: "A lawyer would know that the shareholders do not, in fact, own the corporation. Rather, they own a type of corporate security commonly called 'stock.' As owners of stock, shareholders' rights are quite limited. For example, stockholders do not have the right to exercise control over the corporation's assets." The prominent lawyers Martin Lipton and Steven

35 See EASTERBROOK & FISCHEL, supra note 23, at 63-89.


37 From the managerialist perspective, see Manning, supra note 27, at 1490; Lipton & Rosenblum, supra note 28, at 70-74. From the team theorist perspective, see Blair & Stout, supra note 26, generally; Margaret M. Blair & Lynn A. Stout, Director Accountability and the Mediating Role of the Corporate Board, 79 Wash. U. L.Q. 403, 409 (2001) ("Yet from a logical perspective, the naked claim that shareholders own the corporation is just that--a naked claim."); Lynn A. Stout, Lecture and Commentary on the Social Responsibility of Corporate Entities: Bad and Not-So-Bad Arguments for Shareholder Primacy, 75 S. Cal. L. Rev. 1189 (2002). The arguments of Professors Blair & Stout have also been cited in support of related arguments regarding shareholder duties. See Roberta S. Karmel, Should a Duty to the Corporation Be Imposed on Institutional Shareholders? 60 Bus. Law. 1 (2004).

38 See John Armour & Michael J. Whincop, "Proprietary Foundations of Corporate Law," ESRC Centre for Business Research, University of Cambridge Working Paper No. 2993 (Mar. 2005). Professors Armour and Whincop comment that, "recent developments in the theory of the firm, whilst identifying the significance of allocations of control rights, have failed to explain the role played by property law in facilitating the sharing or partitioning of control between different participants in a firm. An understanding of the significance of the scope of proprietary rights—their ‘in rem’ character—points the way to a more complete explanation of the role played by law in supporting business enterprise. In particular, only property law can provide automatic enforcement of the ‘second-order’ allocations of entitlement to residual control in relation to assets used in productive enterprise." Id. at 13.

39 See Stout, supra note 37, at 1191.
Rosenblum also equate non-ownership of the company's assets, which is a black-letter principle of corporate law,\(^{40}\) with non-ownership of the company itself:

A share of stock does not confer ownership of the underlying assets owned by the corporation. . . . Shareholders have no more claim to intrinsic ownership and control of the corporation's assets than do other stakeholders. . . . The rights we choose to confer on shareholders . . . cannot be justified on the basis of their intrinsic right as the "owners" to control the corporation\(^{41}\) (emphasis added).

This argument almost rises to the level of slight of hand. Except in very rare cases of abuse, the principle of separation of ownership between the shareholders' assets (including their stock in the corporation) and the corporation's assets, together with the limited liability it entails, is for juridical persons universally accepted.\(^{42}\) The fact that shareholders do not own a corporation's separately partitioned assets says absolutely nothing about whether shareholders own the corporation itself. In fact, a primary function of the corporate form is precisely this partitioning of assets.\(^{43}\) Referring to Farwell J.'s classic definition of a share of stock in *Borland's Trustee v. Steel*,\(^{44}\) Prof. Paul Davies succinctly describes the difference between a corporation's status as an owner of assets and as an object owned by shareholders:

The company itself is treated not merely as a person, the subject of rights and duties, but also as a *res*, the object of rights and duties. It is the fact that the shareholder has rights in the company as well as against it, which, in legal theory, distinguishes the member from the debenture-holder whose rights are also defined by contract . . . but are rights against the company and, if the debenture is secured, in its property, but never in the company itself.\(^{45}\)

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\(^{40}\) "Corporate property is owned by the corporation as a distinct legal person; its shareholders have only an indirect interest in the assets and business." *COX, HAZEN & O’NEAL, supra* note 14, at § 7.2; "When a corporation acquires property the title vests in it as a legal person distinct from its shareholders." Henry Winthrop Ballantine, *BALLANTINE ON CORPORATIONS* § 119 (1946).

\(^{41}\) Lipton & Rosenblum, *supra* note 28, at 72 et seq. This failure to grasp the function of the corporate entity in separating the shareholders' ownership of the company from the company's ownership of its assets also crops up in the arguments against what some call "shareholder primacy." Prof. Roberta S. Karmel repeated in 2004: "In reality, shareholders have a property interest in their shares, not in the corporation's assets." *Karmel, supra* note 37, at 1.

\(^{42}\) In an analysis of corporate law in the United States, England, Switzerland, France, Germany, and Japan, a team of international authors observe that "today, limited liability has become a nearly universal feature of the corporate form." *REINER R. KRAAKMAN, PAUL DAVIES, HENRY HANSMANN, GÉRARD HERTIG, KLAUS J. HOPT, HIDEKI KANDA, AND EDWARD B. ROCK, THE ANATOMY OF CORPORATE LAW A COMPARATIVE AND FUNCTIONAL APPROACH* 8-9 (2004).

\(^{43}\) "In our view . . . the separation between the firm's bonding assets and the personal assets of the firm's owners and managers . . . is the core defining characteristic of a legal entity, and establishing this separation is the principal role that organizational law plays in the organization of enterprise." Henry Hansman & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 Yale L.J. 387, 393 (2000).

\(^{44}\) *Borland's Trustee v. Steel* [1901] 1 Ch. 279 at 288.

\(^{45}\) *PAUL DAVIES, GOWER AND DAVIES’ PRINCIPLES OF MODERN COMPANY LAW* 616-17 (7th ed. 2003).
Beyond equating the corporation as an entity with the assets such entity owns, Prof. Stout and Messrs. Lipton and Rosenblum seem to have all taken their understanding of ownership from William Blackstone's *Commentaries on the Laws of England*, which define property as "that sole and despotic dominion which one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the universe." As a result, they assert that the indirectness and non-exclusiveness of the relationship between an individual shareholder and a publicly listed corporation negates a finding of true ownership. Prof. Stout observes:

As a legal matter, shareholders accordingly enjoy neither direct control over the firm's assets nor direct access to them. . . . Thus, while it perhaps is excusable to loosely describe a closely held firm with a single controlling shareholder as "owned" by that shareholder, it is misleading to use the language of ownership to describe the relationship between a public firm and its shareholders.

Messrs. Lipton and Rosenblum are of like mind: "the ownership of a share of stock in a public company is simply not analogous to the ownership of a car or a building . . . . A share of stock is a financial instrument, more akin to a bond than to a car or a building . . . . The owner of the building . . . is an individual . . . in a position to have full knowledge . . . . [and who] generally views the property or business as a complete entity . . . . In contrast, the shareholder of the large public corporation is one of a far-flung, diverse, and ever-changing group." These observations of Prof. Stout and Messrs. Lipton and Rosenblum on the difference between an owner in "sole and despotic dominion" of her property and the position of a shareholder in a modern public company do not really tell us much about whether shareholders own their corporations.

Most experts no longer understand the nature of property in the "despotic dominion" terms set forth by Blackstone in the eighteenth century, but rather see property as constituted by various types of "bundles" of different kinds of rights, with variations in the bundle constituting different kinds of interests. In the list assembled by A.M. Honoré, such rights include not only the more intuitively

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46 WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND, Book 2, chapter 1 (1765-1769).
47 Stout, supra note 37, at 1191.
48 Lipton & Rosenblum, supra note 28, at 72-73. Messrs Lipton and Rosenblum appear to take literally an argument that Dean Manning presented about 40 years earlier only analogically in a description of a shareholder's economic and psychological position: "[T]he model is useful because, in the case of a large, publicly-held modern corporation, it approximates reality. Except in the context of the closely-held corporation, the limited notion of the shareholder as owner of a 'share' – a reified legal and economic bundle – is surely more valid than our historical image of the shareholder as 'owner' of the corporation.' To view the shareholder as the owner only of a share of stock – as a bondholder is said to own 'the bond' – conforms for more closely to the shareholder's own expectations and describes far more accurately what he in fact handles as his own – buying, selling and giving away." Manning, supra note 27, at 1492.
appealing rights to "use" and "manage", but also "the right to the income of the thing, the right to the capital, the right to security . . . the rights or incidents of transmissibility and absence of term . . . and the incident of residuarity." The incident of "residuarity" is perhaps the best known of the bundle in contemporary corporate law. As Judge Frank Easterbrook and Prof. Daniel Fischel have explained: "Investors bear the risk of failure (sometimes we call them 'risk bearers') and receive the marginal rewards of success. Equity investors are paid last, after debt investors, employees, and other investors with (relatively) 'fixed' claims. These equity investors have the 'residual' claim in the sense that they get only what is left over – but they get all of what is left over." Indeed, shares of stock embody a pro rata right to the residual assets of a corporation upon dissolution. However, "residuarity" has more than a temporal (i.e., last in line) meaning. As Prof. John Armour and the late Prof. Michael Whincop note: "Residual' implies that the rights to control over all states of the world which are not specified by law or contract *ex ante*. Residuarity matters because it is still possible to allocate residual rights even if specific directions about what should (not) be done in particular circumstances cannot be written or enforced." Thus, when a power has not been provided for in any of the statutes or contractual documents allocating control in a firm, residuarity would leave that power with the firm's owners.

Many other property rights and incidents are embodied in shares of stock. If the charter does not provide otherwise, common shares in a stock corporation are without term. Most corporate statutes provide shareholders with (rarely used) residual control over a corporation that is apparently absolute, in that management may be taken away from the board of directors in the corporate charter. Even in the weaker form of shareholder control customarily used, shareholders have control though the
right to elect or remove directors, \(^{56}\) and veto rights over a merger, \(^{57}\) or the transmission of the corporate assets to a third party. \(^{58}\) In addition to the right to receive capital as a residual claimant at dissolution, as discussed above, shareholders also have a statutorily recognized right to receive income in the form of dividends, \(^{59}\) and such distributions cannot be invalidated by creditors if they comply with the statutory capital maintenance rules. Shareholders also have the right to exclude directors, third parties, and other shareholders from their property through various types of judicial remedies under corporate law statutes, such as actions against management for breach of statutory or common law fiduciary duties, including self-dealing, waste of corporate assets, dilution of their pro rata interest though the issuance of stock below par value, or a failure of any stockholder to pay the subscription price. \(^{60}\)

The pro rata and cooperative natures of these interests in property and rights over property do not decrease their proprietary aspect, but are precisely the genius of the share of stock, as it "protects the entitlements of co-owners against opportunistic attempts by one of them to grant entitlements to third parties that undermine the other co-owners’ claims. It does so by making their entitlements to the assets generally enforceable. Hence it affects an open-ended set of potential third parties who might deal with the firm." \(^{61}\) Unlike a contract right, ownership will "run with the assets," \(^{62}\) and a shareholder's right to residual assets upon a corporation's liquidation allows an action for recovery of the property if such assets are improperly transferred to a third party, including the holders of a different class of shares. \(^{63}\) The design of this property interest significantly reduces monitoring costs. \(^{64}\)

\(^{56}\) Del. Code Ann. tit. 8, §§ 211(b) and 141(k); and §§ 8.03(c) and 8.08(a).

\(^{57}\) Del. Code Ann. tit. 8, § 251(c), and § 11.04(b).

\(^{58}\) See, e.g., Del. Code Ann. tit. 8, § 271(a), and § 12.02 RMBCA.

\(^{59}\) See, e.g., Del. Code Ann. tit. 8, §§ 170 and 154; § 6.40 RMBCA.

\(^{60}\) See, e.g., Del. Code Ann. tit. 8, § 327; § 7.40 RMBCA.

\(^{61}\) Armour & Whincop, supra note 38, at 3.

\(^{62}\) “For our purposes, the attribute that distinguishes a property right from a contract right is that a property right is enforceable, not just against the original grantor of the right, but also against other persons to whom possession of the asset, or other rights in the asset, are subsequently transferred. In the parlance of property law, the burden of a property right “runs with the asset.”” Henry Hansmann & Reiner R. Kraakman, Property, Contract and Verification: The Numerus Clauses Problem and the Divisibility of Rights, 31 J. Leg. Stud. 373, 378-379 (2002).

\(^{63}\) Mohawk Carpet Mills, Inc. v. Delaware Rayon Co., 110 A.2d 305 (Del. Ch. 1954). Another interesting case involving the property rights attaching to shares is the right of a shareholder to separate dividend rights from a share when it is sold in close proximity to the annual meeting at which dividends will be declared, thereby causing the profit rights accruing to a share of stock purchased ex dividend spring back only after such immediately succeeding declaration, and certainly giving the original shareholder an actionable right against any subsequent purchaser who happens to erroneously receive the dividends declared at such meeting.

\(^{64}\) Armour & Whincop, supra note 38, at 11.
Shares need not express fee simple interests in land to embody property rights. As is the case with most interests in property, the nature of the interests they embody are tailored to the purposes they serve. Courts agree on this point.

B. The Nature of a Shareholder’s Property Interest

Perhaps it is the intangible nature of the interest embodied in a share of stock that has confused the opponents of shareholder voice. The *Fletcher Cyclopedia of the Law of Private Corporations* points out that, "shares of stock are property, but they are intangible and incorporeal property, an 'incorporeal, intangible thing,' existing only in abstract legal contemplation. There are cases, however, in which they have been referred to as tangible property, in some respects at least; but it would seem that, in such cases, the court had reference rather to the physical representative of the shares, that is, to the share certificate, than to the shares themselves." Under Delaware Law, as the Delaware Court of Chancery has explained, "[a] certificate of stock is evidence of ownership, in the nature of a chose in action." The stock certificate is *evidence* of the share of ownership, which itself is not tangible, and thus the share, quota, or portion of the corporation owned by the shareholder cannot be taken into possession the way the certificate that evidences it can be. A "chose in action is a known legal

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65 “The ‘bundle of sticks’ conception views the law of property as creating an almost random variety of rights and duties that the law recognizes in the standard owner. While Honore’s list of property ‘incidents’ has been extremely influential, there is little agreement among scholars as to the relative importance of sticks in the bundle, and even as to the usual bundle’s contents.” Bell & Gideon, *supra* note 49, at 53.

66 In addressing federalist issues of taxation, the U.S. Supreme Court has observed that, "The interest of the shareholder entitles him to participate in the net profits earned by the bank in the employment of its capital, during the existence of its charter, in proportion to the number of his shares; and, upon its dissolution or termination, to his proportion of the property that may remain of the corporation after the payment of its debts. This is a distinct independent interest or property, held by the shareholder like any other property that may belong to him." Van Allen v. The Assessors, 70 U.S. 573, 584, (1865). The Supreme Judicial Court of Massachusetts, citing the foregoing decision 50 years later, also found classic property rights to exist in the shares of a stock corporation: "It is an incident of such shares that the owner is entitled to participate in the net profits earned, to enforce the use of its capital for its corporate purposes, to restrain abuses of corporate powers, and to receive his proportion of the property of the corporation remaining after the payment of its debts upon its dissolution. Bellows Falls Power Co. v. Com., 222 Mass. 51, 58; 109 N.E. 891, 895 (1915). In one among the many decisions distinguishing stock from contractual debt for tax purposes, the Federal Circuit has observed: "Stock is an equity; it represents an ownership interest. It is to be distinguished from obligations such as notes or bonds which are not equities, and represent no ownership interest. . . . The characteristics of stock are a right to participate proportionately in all profits, and in management, and in the distribution of net assets on liquidation; the characteristics of a note are a definite obligor, a definite obligee (either by name or designation), a definitely ascertainable obligation, and a time of maturity, either definite or that will become definite." U.S. v. Evans, 375 F.2d 730 (9th Cir. 1967), citing: 3 PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION 170 (1934).

67 *See supra* note 48 and accompanying text displaying the importance that Messrs. Lipton & Rosenblum place on a share of stock not being the same as a car or a building.

68 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5097 (updated to 2004).

expression used to describe all personal rights of property which can only be claimed or enforced by action and not by taking physical possession. Thus, it has the name "chose" (French for thing) in "action", as opposed to thing in possession. Again, possession is impossible because a "[c]hose in action is a thing incorporeal and only a right."

Various U.S. jurisdictions have come to terms with this form of intangible property in different ways. New Jersey has retained the concept of "chose in action," finding that "[t]he share in the corporation constitutes a chose in action which is an intangible property right. The certificate itself, however, the document evidencing stock ownership, is considered tangible personal property." In a 1957 decision, the Court of Appeals of New York received the false impression that "chose in action" was understood in England and Massachusetts as a contract, rather than a property right, and thus steered clear of the term in order to affirm that shares are "personal property" and subject to the rules of transfer for property. In Illinois, shares of corporations are choses in action that constitute incorporeal rights. The Court of Appeal of Louisiana has found that "shares of stock in a corporation represent not money but a proportionate interest in the rights and property of the corporation, whatever they may be and wherever they are, subject to the corporation's obligations." The California Court of Appeals has recently applied a similar concept to stock options, explaining that, "[a]n employee stock option grant is thus 'not an expectancy but a chose in action, a form of property . . . ' susceptible of division in spite of being contingent or not having vested." Thus, the property right evidenced by a share of stock is no less a property right because it does not vest in specifically identified assets, like specified "cars or buildings" belonging to General Motor's

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71 "In English law property is classified into real property ("land, tenements and hereditaments") and personal property. The latter is divided into chattels real (interests in land, e.g. a lease) and chattels personal (all property other than real property and chattels real). Chattels personal are subdivided into things (or "chooses") in possession (which can be recovered by reduction into possession) and things (or "chooses") in action (which can only be recovered by action in the courts). The former includes tangible moveable property, the latter intangible personal property such as rights and debts. Shares are "property" within R.S.C. 1965, Ord. 86: Woodlands v Hinds [1955] 1 W.L.R. 688, 690. They are personal estate ( s 182(1)(a))." SWEET AND MAXWELL, PALMERS COMPANY LAW 2.006 (2003).

72 VAINES, supra note 70, at 13.


74 See Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 541; 161 N.Y.S.2d 418, 422 (1957). For the actual position in Massachusetts see Bellows Falls Power, supra note [•], and with regard to England see PALMERS COMPANY LAW, supra note 71 and DAVIES supra note 45 and accompanying text.


78 Ballantine, supra note 136, at 289.
inventory, just as the property right in a share of stock does not disappear merely because under Article 8 of the Uniform Commercial Code a shareholder has only a pro rata property interest in all shares of the same type that are held in fungible bulk by her broker.\textsuperscript{79}

Perhaps the shared nature of this interest makes it seem less like our intuitive picture of Blackacre, but the sharing aspect of a shareholder's interest is essential to the corporate form, and history has shown that property interests are constructed and evolve to meet the particular legal and economic purposes they are meant to serve.\textsuperscript{80} Prof. Armour and the late Prof. Whincop argue that a corporation consists of "proprietary foundations" and a "contractarian superstructure."\textsuperscript{81} These two mechanisms work to allow joint sharing between multiple owners, delegation of entitlements to managers, and sequential sharing (triggered by default) between owners and creditors.\textsuperscript{82} The division of entitlements can be structured in a "contractarian" manner through agreements, corporate charters and corporate statutes, but "[s]econdly—and more importantly—the law provides mechanisms whereby the scope of the parcels of entitlements given to each participant is made, to use Hohfeld’s term, ‘multital’. That is, their entitlements are protected not just against other participants to the voluntary arrangement, but against persons generally. In short, the arrangements are given proprietary effect."\textsuperscript{83} This allows free transferability of shares to third parities, who will assume exactly the same rights and restrictions as all holders of the same class of shares, without conducting additional contracting. Thus, the absence of "despotic dominion" over the corporation, i.e., the lack of an ability to use or dispose of the assets in an individual capacity, does not negate that property law still serves as a workhorse to enable the multifaceted nature of the corporate structure to function.\textsuperscript{84} In light of this, Prof. Stout's recommendation – "The time has come to lead the 'shareholder ownership' argument for shareholder primacy to the back of the barn, and to put it out of its misery."\textsuperscript{85} – would seem inappropriate.

\textsuperscript{79} See § 8-503(b) Uniform Commercial Code: "An entitlement holder's property interest with respect to a particular financial asset . . . is a pro rata property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset."

\textsuperscript{80} See Mahoney, supra note 24, at 877-78.

\textsuperscript{81} Armour & Whincop, supra note 38, at 16.

\textsuperscript{82} Id. at 15.

\textsuperscript{83} Id. at 16.

\textsuperscript{84} Id. at 19.

\textsuperscript{85} See Stout, supra note 37, at 1192.
III. SHAREHOLDER DUTIES

Perhaps the strongest argument for management dominance of corporations is the finely tuned body of fiduciary duties that courts have designed to restrict self-dealing by corporate directors. The corresponding assertion that shareholder actions are not restricted by fiduciary duties is, however, untrue. This assertion tends to ignore both the fiduciary duties to which shareholders have been subjected and the fact that judicial imposition of duties arises only where there is at least an allegation of an abuse. A court would rarely define a duty restricting a power before the power is even used. Therefore, the limited state of shareholder fiduciary duties simply marks the relatively narrow boundaries of shareholder power ordinarily exercised. It is also argued that any shareholder nominee to the board would be somehow less useful to the corporation because nominated by a shareholder. This argument resembles the slight-of-hand confusion between ownership of a company and ownership of the company's assets, which is discussed above. Absent particular rights for a class of securities, members of the board are elected by the same, required majority and subjected to the same fiduciary duties regardless of who nominates them. Opponents of shareholder voice also ignore the extensive and restricting duties imposed on shareholders under the Securities Exchange Act of 1934 (the "Exchange Act"), particularly §§ 13 and 16.

A. Shareholder Fiduciary Duties

Fiduciary duties arise in a relationship in which "one party (the 'fiduciary') acts on behalf of another party (the 'beneficiary') while exercising discretion with respect to a critical resource belonging to the beneficiary." What distinguishes a fiduciary from many other contracting parties . . . is that a fiduciary exercises discretion with respect to a critical resource belonging to the beneficiary, whereas most contracting parties exercise discretion only with respect to their own performance under the contract.

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87 The use of declaratory judgments can extend beyond preventative measures, and courts may no longer in all circumstances require that a defendant have already violated a duty owed to the plaintiff. Restatement of the Law, Second, Judgments § 33 (1982). However, the opponents of shareholder voice do not allege any specific circumstances to exist in which shareholders lack a duty that would be prerequisite for them to have more power.
88 See Lipton & Rosenblum, supra note 28, at 82-83, and Karmel, supra note 37, at 9-14.
89 See note Part II.A.
94 Id. at 1403.
beneficiary, a managing partner and her co-partners, and an agent and a principal. "As the number of relations similar to existing fiduciary relations increased, the courts began to analogize the new relations to the established fiduciary prototypes, and to apply the rules of the prototypes to the new relations. Corporate law, for example, frequently analogizes directors to trustees, agents, and managing partners." Such analogies are successfully made for the relationship between a corporate director and a shareholder, as it displays all of the qualities specified in the definition of the fiduciary relationship quoted at the beginning of this paragraph: the shareholders elect the director to act on their behalf by exercising expert discretion regarding the management of the corporation, which is an asset belonging in pro rata shares to each holder of a chose in action embodied in the corporate stock.

Messrs. Lipton and Rosenblum strongly agree that directors are fiduciaries. They stress that, "directors and officers of the corporation are the only constituency that has legal obligations to act in the best interests of the corporation." They recognize no similar duty for shareholders: "In their capacity as shareholders, the legal system allows them to act purely in their self-interest. They are not fiduciaries and they do not owe legal duties to the corporation, other shareholders, or the corporation's other constituencies." This is their primary argument against increased shareholder influence. Their assertion is incorrect. Shareholders have borne fiduciary duties at least since the late 19th century. Currently under Delaware law, and the laws of most U.S. jurisdictions, a shareholder owes a fiduciary duty to the corporation and any minority shareholders if he either "owns a majority in or exercises control over the business affairs of the corporation." If a controlling equity stake is not obviously present, a plaintiff may still prove the existence of a relationship triggering a fiduciary duty by demonstrating domination of "a minority shareholder through actual control of corporation

97 Lipton & Rosenblum, *supra* note 28, at 73.
99 See *Menier v. Hooper's Telegraph Works* [1873-74] LR 9 Ch. App. 350 (The majority shareholder may not liquidate a company in order to unfairly profit from purchase of its assets to the detriment of the minority.); Ervin v. Oregon Ry. & Nav. Co., 27 F. 625 (C.C.S.D.N.Y. 1886) (A majority that controls the corporation freely assumes the trust relation occupied by the corporation towards its stockholders.).
100 See *Cox, Hazen & O'Neal*, *supra* note 14, at § 11.10, and, disagreeing with the imposition of such duties, Paula J. Dalley, *The Misguided Doctrine of Stockholder Fiduciary Duties*, 33 Hofstra L. Rev. 175 (2004).
conduct. When such control exists, a controlling shareholder stands on both sides of transactions that it enters into with the controlled company, and such transactions are subjected to the strict, "intrinsic fairness" or "entire fairness" analysis, which is the strictest standard applied in Delaware corporate law. This is the standard that is also applied to directors when they stand on both sides of a transaction. Thus the fiduciary principles applied to directors and shareholders are of like kind. The existing differences are caused by the different powers exercised by directors and shareholders.

Leading members of and experts on the Delaware Chancery Court explain that fiduciary duties in Delaware corporation law have developed as ex post judicial controls filling a vacuum created by receding, ex ante mandatory restrictions on director behavior, thus illustrating how fiduciary duties tend to develop where powers susceptible of abuse are present:

Over the course of the twentieth century, the mandatory features of the statutory law gradually decreased. Statutes became increasingly elegant and flexible, continuously moving away from a mandatory or prescriptive model and ever closer to a pure contractual or enabling model. As a consequence, what emerged as a counterpoint to the evolution of the enabling model of corporation law was the second key function of the law of corporations: the ex post judicial review of the actions of corporate officers and directors, measured by fiduciary principles. Fiduciary review imported into corporate law the centuries-old equity tradition that subjected the conduct of fiduciaries to judicial supervision. Corporate directors came to be viewed as a species of fiduciary, not so constrained as trustees or executors to be sure, but subject nonetheless to a pervasive duty of loyalty when exercising their broad powers over corporate property and processes.

If we recall the definition of fiduciary duty offered at the beginning of this section, we can see how the Delaware courts could import fiduciary principles for application to shareholders as circumstances arose in an economy in which large, networked corporate groups have become more and more common. The three, primary elements of a fiduciary relationship according to the cited definition are that the fiduciary (i) acts on behalf of another party (ii) while exercising discretion (iii) over a critical resource belonging to the beneficiary. Major decisions on the fate of a corporation, such as its merger with another firm or its dissolution, must normally be approved by a majority vote of the stock entitled to vote on such decisions. It is a characteristic of majority rule that, when a shareholders' resolution is duly adopted, the minority must acquiesce to the majority, whom the

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103 Sinclair Oil Corporation v. Levien, 280 A.2d 717, 720 (Del. 1971); Kahn, 638 A.2d at 1115.
104 Gilson & Gordon, supra note 99, at 791.
107 For a detailed discussion of each of these elements, see Smith, supra note 93, at 1402-04.
108 See, e.g., Del. Code Ann. tit. 8, §§ 251(c) and 271(a).
minority has (pursuant to the governance rules) essentially appointed as its agent to exercise discretion (in accordance with the shareholders' resolution) regarding the corporation (an asset belonging to all of the shareholders). Accordingly, in the rare cases in which shareholders are able to exercise power over the corporation, such power may be understood to be subject to fiduciary duties. The cases prove this to be true.

The 1971 case of *Sinclair Oil Corp. v. Levien* presents a good example of the powers that have come to be typical of holding companies in multinational groups and the corollary application of fiduciary duties. Among its many other subsidiaries, Sinclair Oil Corporation held 97% of the equity of Sinclair Venezuelan Oil Company ("Sinven"), and elected its entire board of directors. As is typical of a corporate group, Sinclair caused Sinven's board to enter into a supply contract with another one of its subsidiaries, and the contract specified quantities and terms of payment. When the subsidiary breached the quantities and payment terms, Sinclair caused Sinven to refrain from enforcing due performance of the contract. The Court found that Sinclair had engaged in self-dealing with Sinven, that it had benefited itself to the detriment of Sinven's minority shareholders, and that, like a director transacting with a corporation, Sinclair was required to prove that "causing Sinven not to enforce the contract was intrinsically fair to the minority shareholders of Sinven." Another typical exercise of holding company power is seen when the controlling shareholder seeks to reorganize the group holding structure. The 1994 case of *Kahn v. Lynch Communications Systems, Inc.*, addressed efforts by a 43% shareholder, Alcatel U.S.A. Corp., to prevent its subsidiary, Lynch Communications System, from merging with another company, and instead force it to become a wholly owned member of the corporate group. Although Alcatel held less than 50% of Lynch's stock, the

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109 Such "cooperative efforts," even if not formally regulated by statutory rules, always present a certain agency relationship. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, in Michael C. Jensen, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS 83, 86 (2000). Rather than looking at this as a contractual, agency relationship, the delegation of power to the majority could also be understood as an inherent characteristic of the property interests that shareholders hold in the firm. See the discussion of joint-owner agency problems, in Armour & Whincop, supra note 38, at 10. Prof. Smith also notes that his own "description of fiduciary relationships bears a strong resemblance to the description of 'firms' in the property rights theory pioneered by economists Sanford Grossman, Oliver Hart, and John Moore . . . . The central insight of the property rights theory of the firm is that an appropriate allocation of ownership rights over the assets of a firm reduces the likelihood that one party will unfairly take advantage of the other participants within the firm." Smith, supra note 93, at 1404-05.

110 280 A.2d 717 (Del. 1971).

111 *Sinclair*, 280 A.2d, at 719.

112 *Id.* at 722-23.

113 *Id.* at 723.

114 *Id.*

115 638 A.2d 1110 (Del. 1994).

116 *Kahn*, 638 A.2d, at 1112.
Delaware Supreme Court found that it was a controlling shareholder because it was able to dominate Lynch’s board. Because Alcatel was found to have the power to dominate Lynch, the fiduciary duties of a controlling shareholder were attributed to it, and its actions were subjected to "the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder [with its subsidiary, i.e.,] . . . entire fairness." These, together with many other cases, show that when shareholders have the power to control a corporation and in so doing prejudice the corporation or the rights of the minority, such shareholders are held to a fiduciary standard approaching, if not identical to, that of directors.

The fiduciary duties of shareholders have been extended as far as necessary to cover the actual, dominating power of shareholders, which – absent a corporate group in which a powerful holding dominates a network of subsidiaries – is in practice not very far. Where, however, a minority shareholder is given significant control over the fate of the corporation, such as where because of a high supermajority provision the minority is able to block corporate action, courts have found that also a minority has fiduciary duties. For example, the Appeals Court of Massachusetts has found that a charter provision requiring an 80% majority of the capital to approve specified actions, "may have substantially the effect of reversing the usual roles of the majority and the minority shareholders. The minority, under that provision, becomes an ad hoc controlling interest." Individual shareholders are also capable of working in concert to exercise control. The American Law Institute's Principles of Corporate Governance explicitly include power obtained "pursuant to an arrangement or understanding with one or more other persons" as creating the status of "controlling shareholder."

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117  Id. at 1114-15.

118  Id. at 1117.

119  See, e.g., In re Digex, Inc. Shareholders Litigation, 789 A.2d 1176 (Del. Ch. 2000) (In the context of negotiating a possible parent-subsidiary merger, the subsidiary's waiver of the protective devices such as § 203 Delaware General Corporation Law must be evaluated under the entire fairness standard.); In re Pure Resources, Inc. Shareholders Litigation, 808 A.2d 421 (Del. Ch. 2002) (In the context of a squeeze-out tender offer, the subsidiary should be empowered to use all defensive measures against the controlling shareholder that are acceptable for a third party tender offer).

120  Smith v. Atlantic Properties, Inc., 422 N.E.2d 798, 802 (1981) (In a close corporation with four shareholders, one shareholder's refusal to approve dividends needed to reduce danger of an assessment under the Internal Revenue Code violated the shareholder's fiduciary duty by recklessly running serious and unjustified risks that penalty taxes – which were in fact then assessed – would be assessed.) This case presented a clear measure of whether the decision of the minority had breached the shareholder's fiduciary duty. In the case of a minority that refuses to tender its shares into an offer with a minimum tender requirement, the courts can be less sure that the minority has breached its duty by failing to tender and causing the collapse of the offer, rather than acting on the basis of legitimate business reasons. See Medical Air Technology Corporation v. Marwan Investment, Inc., 303 F.3d 11, 21 (1st Cir. 2002).

121  THE AMERICAN LAW INSTITUTE, supra note 101, at § 1.10.
Prof. Roberta Karmel asked in the title of a 2004 law review article: "Should a duty to the corporation be imposed on institutional shareholders"?  

This query does not seek to tie into and extend the existing duties of shareholders in order to address more recent problems, but rather offers other findings and recommendations. Prof. Karmel argues that, during the "new economy" bubble of the 1990's, institutional investors exercised power that "pressured corporate executives to think like shareholders and be compensated in equity." She sees this as the cause of an increase in "executive compensation to historically high levels." Executive management was further subjected to "[p]ressures by institutional investors for ever higher quarterly earnings . . . [until] [t]he temptation to manage earnings became too great." To make matters worse, after shareholders created a dangerous situation by corrupting management's compensation culture and pressuring them to stretch the truth, they then "did a poor job of analyzing corporate finances and prospects, or at the very least acquiesced in unrealistic valuations," which caused the tragic bubble. From the facts she describes and the blame she ascribes, it would seem that Prof. Karmel is proposing to impute a duty of careful monitoring on shareholders. Her solution, however, is at least in part to subject the exercise of shareholder voice itself – even absent actual control – to the fiduciary duty (of loyalty) borne by controlling shareholders: any shareholder that nominates a candidate to the board "in opposition to the selection by an existing board . . . in appropriate cases . . . [should] be held to the same kind of duties that are imposed on controlling shareholders." That this recommendation is unworkable can be seen using an analogy to a single director and the board as a body: it would be equivalent to imposing sole liability for a board resolution on an individual director who proposes the item, which the entire board then approves. To impute controlling shareholder liability to a nominating shareholder would (i) ignore the absence of actual shareholder influence, (ii) the intervening majority vote to elect the director, and (iii) the director's own fiduciary duties in exercising her discretion, and would (iv) also discount the value of the duty placed on any shareholder who actually does exercise control.

In addition to imposing this fiduciary duty, Prof. Karmel has an additional proposal. She also recommends that the nominating shareholders "undertake to monitor the directors they propose and

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122 Karmel, supra note 37, at 1.
123 Id. at 3. This assertion that institutional investors twisted the arms of executive management until they accepted outrageous compensation packages is not only counterintuitive, but is also contrary to at least anecdotal evidence. For example, in the Delaware case of State of Wisconsin Investment Board v. Peerless Systems Corp., No. 17,637, 2000 Del. Ch. LEXIS 170 (Del. Ch. Dec. 4, 2000), shareholders attempted to vote down the board's attempt to expand a stock option plan, only to be meet with board tactics designed to thwart the shareholder's vote by manipulating the machinery used to effect such vote.
124 Karmel, supra note 37, at 8.
125 Id. at 9.
126 Id. at 7.
127 Id. at 20-21.
remain shareholders for the duration of the terms of office of such directors.\textsuperscript{128} She does not propose a similar duty for nominations made by board members. The duty would not be fiduciary duty, but rather a mandatory transfer restriction or lock-up on the shares participating in such nominations for the duration of the director's term of office. It cannot be assumed that Prof. Karmel intends this proposal to be taken seriously, but if it were, its potential, prejudicial impact on the liquidity of an issuer's securities, the markets as a whole, and the severe chilling effect on a shareholder's right to exercise voice, are obvious. The threat of liability and restricted ownership would effectively prevent all but the most committed shareholders from nominating directors.\textsuperscript{129} However, this elimination of shareholder voice would encourage use of a more "effective" option: exit. Prof. Karmel explains: "Probably the most effective lever institutions have is their ability to drive down the price of a company's stock by refusing to invest or selling shares."\textsuperscript{130} Having offered this alternative, however, she does not look into the probability that promoting use of exit and discouraging the use of voice would create exactly the kind of short-term oriented, low-monitoring shareholder that she apparently seeks to censure.\textsuperscript{131}

\section*{B. Duties under the Exchange Act}

\textit{1. Reporting Duties under § 13(d) Exchange Act}

We have seen that courts imposed fiduciary duties on corporate actors where necessary to prevent those with power over the assets of others from extracting undue rents.\textsuperscript{132} During much of the period in which courts were developing these duties in corporate law, the federal government and the U.S. Securities and Exchange Commission (SEC) were codifying new, mandatory provisions of securities law to guard against similar abuses. Although not fiduciary duties, per se, obligations like the regular disclosure of related-party transactions,\textsuperscript{133} for example, are designed to counter the same type of abuses that fiduciary duties are used to control.\textsuperscript{134} The securities laws impose numerous duties

\textsuperscript{128} \textit{Id.} at 20-21.

\textsuperscript{129} As early as 1991, Prof. Coffee outlined the broad lines of a policy to encourage shareholder monitoring. Such a policy should try to (i) free shareholders from conflicts of interest, (ii) encourage shareholders to take stakes large enough to make monitoring worth while, (iii) encourage shareholders to adopt a holding term that is long enough to make monitoring a good investment, and (iv) structure contracts with external managers in such a way that they have an incentive to engage in monitoring. \textit{See} Coffee, \textit{Liquidity vs. Control}, \textit{supra} note 2, at 1336-42.

\textsuperscript{130} \textit{Id.} at 14.

\textsuperscript{131} \textit{See} Lawrence E. Harris, \textit{supra} note 13.

\textsuperscript{132} \textit{See} Allen \textit{et al.}, \textit{supra} note 106.

\textsuperscript{133} Pursuant to Regulation S-K under the Exchange Act, a registered company must disclose any transaction exceeding $60,000 between itself or any of its subsidiaries and a shareholder who owns more than 5 % of any class of its voting securities or a family member of such shareholder. 17 C.F.R. § 229.404(a).

\textsuperscript{134} "The core fiduciary duty of a trustee is an obligation to act in the interest of the beneficiary of the trust. The most important aspect of this obligation is a duty to avoid self-interested transactions." Smith, \textit{supra} note 93, at 1453.
on the shareholders of registered companies. This subsection will discuss only two sets of such duties: the disclosure of holdings pursuant to § 13 Exchange Act and the treatment of shareholders as insiders under § 16 Exchange Act.

Although designed to prevent oppressive, surprise takeovers, the rules under § 13 Exchange Act affect a much broader area of shareholder activity, and can present a significant obstacle to coordinated exercise of shareholder voice in normal governance. Under Rule 13d, any person who acquires directly or indirectly more than 5% of either the "voting power" or the "investment power" of any class of equity security registered under § 12 Exchange Act, must file a Schedule 13D with the SEC within 10 days after the acquisition. A "person" includes "two or more persons" who agree "to act together for the purpose of acquiring, holding, voting or disposing of equity securities." This concept may be necessary to catch coordinated takeover activity, but it also works to restrict valuable shareholder monitoring. The threat of aggregation into a group can prevent shareholders with small holdings from coordinating action with their fellow shareholders in connection with an annual meeting, lest they be found to "act together for . . . voting" their shares and trigger the requirements of § 13.

Although mere informal discussions among shareholders regarding management's performance has been found not to constitute a "group" for purposes of § 13(d)

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136 This paper will not discuss the numerous duties connected with the solicitation of proxies, except in a brief, historical overview presented in Part V.

137 "Voting power" includes "the power to vote, or to direct the voting of, such security." 17 C.F.R. § 240.13d-3(a)(1).

138 "Investment power" includes "the power to dispose, or to direct the disposition of, such security." 17 C.F.R. § 240.13d-3(2).

139 Securities must be registered under § 12 of the Exchange Act if either (i) if they are listed on a national securities exchange (§ 12(a) Exchange Act) or (ii) if the issuer of the securities has more than 500 shareholders and total assets exceeding $10 million (§ 12(g) Exchange Act in connection with Exchange Act Rule 12g-1, 17 C.F.R. § 240.12g-1). In addition to securities registered under § 12 Exchange Act, Rule 13d-1 also applies to "any equity security of any insurance company which would have been required to be so registered except for the exemption contained in section 12(g)(2)(G) of the Act, or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940." 17 C.F.R. § 240.13d-1(i).

140 17 C.F.R. § 240.13d-1(a).

141 17 C.F.R. § 240.13d-5(b).
Exchange Act,\textsuperscript{142} the type of more formal coordination that is actually necessary to have an impact on governance could well trigger the requirement.\textsuperscript{143} Such application of § 13 Exchange Act to mutual consultation and coordination in preparation for an annual meeting – a prerequisite to effective shareholder monitoring – would seem, however, in no way in line with the legislative purpose of this provision of the Williams Act.\textsuperscript{144}

A Schedule 13D must be filed with the SEC within 10 days after either exceeding the 5% threshold or forming a group whose aggregate holdings exceed such threshold.\textsuperscript{145} In a Schedule 13D, aside from specifying the securities purchased, the shareholder and each member of a group, must file:

- Name(s), citizenship(s), place(s) of incorporation and taxpayer identification number(s);
- Details regarding any judgments against the shareholder(s) under state or federal securities laws or convictions under criminal laws during the last, five years;
- The source of funds or other consideration used or to be used in making the purchases as required (with a copy of an lending agreements to be attached as an exhibit);
- The purpose or purposes of the acquisition of securities, in particular any plans to purchase or sell additional securities, effect an extraordinary corporate transaction, such as a merger, reorganization, liquidation, or sale of assets, plans to change the composition of the current board or management, or amend the company's charter or by-laws, or plans to delist or deregister any class of the company's securities;
- The aggregate amount of shares beneficially owned (with a breakdown within the group);
- A description of any transactions in the class of securities reported on that were effected during the past sixty days; and
- A description of all contracts and understandings – such as for the purchase, sale, pledge, call, put or voting of the securities – among the reporting persons and the company (with a copy of any written agreements to be attached as an exhibit).\textsuperscript{146}

It is understandable that many shareholders – absent an actual intent to launch a tender offer – would prefer to exit by selling their shares or accept the risks of bad management rather than to run the risk of having to pay for the preparation of a Schedule 13D in which they are forced to make the above disclosures, immediately update the disclosure with each one percent change in the (group's) aggregate

\textsuperscript{142} Bath Indus., Inc. v. Blot, 427 F.2d 97, 110 (7th Cir. 1970).

\textsuperscript{143} Evidence of a group for these purposes has been found where there is a common plan and goal, a coordination of activities and communications, public expression of a position among the shareholders, and parallel and continued purchases of the company's shares during a specific time period. LOS & SELIGMAN, supra note 15, at § 6-D-2.b, note 144, citing Champion Parts Rebuilders, Inc. v. Cormier, 661 F. Supp. 825, 850 (N.D. Ill. 1987).

\textsuperscript{144} The legislative purpose of this section of the Williams Act is quite clear: "The purpose of this Section is to prevent "a group of persons who seek to pool their voting or other interests in the securities of an issuer from evading the provisions of the statute because no one individual owns more than [the triggering threshold] percent of the securities." S. Rep. No. 550, at 8 (1967); H.R. Rep. No. 1711, at 8-9 (1968), discussed in LOS & SELIGMAN, supra note 15, at § 6-D-2.b, note 137.

\textsuperscript{145} 17 C.F.R. § 240.13d-1(a); § 240.13d-5(b)(1).

\textsuperscript{146} 17 C.F.R. § 240.13d-101, Items 1-7.
holding, and subject themselves to significant potential liability on the basis of these filings. As this rule was adopted to address takeovers, it is difficult to understand why it applies to ordinary governance activities.

An alternative, less intrusive Schedule 13G that must normally be updated only annually was made available in 1978 for certain institutional investors who have "acquired such securities in the ordinary course of . . . business and not with the purpose nor with the effect of changing or influencing the control of the issuer." In 1998, the SEC amended Schedule 13G to expand the form's use beyond institutional investors, to other investors, provided that they are "passive". The important question for shareholders who desire to participate in governance is, of course, whether the actions that would make up monitoring activity constitutes "influencing the control of the issuer." In its 1998 release, the SEC provided some useful guidance on where it sees the line between "passive" and "active" investors. It listed the following factors that would be taken into consideration:

- Purchase of securities in the ordinary course of a business that, by its nature, does not seek to acquire control of companies indicates passivity;

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147 Any "material increase or decrease in the percentage of the class beneficially owned" must promptly be disclosed in an amendment to the existing Schedule 13D, and any "acquisition of disposition . . . in an amount of one percent or more of the class of securities shall be deemed 'material' for purposes of [the Rule]; acquisitions or dispositions of less than those amounts may be material, depending upon the facts and circumstances." 17 C.F.R. § 240.13d-2(a).

148 Declarations and documents "filed" with the SEC are subject to civil liability for misstatements and omissions pursuant to § 18 Exchange Act, as well as the penalties of fine and imprisonment pursuant to § 32 Exchange Act.

149 The adopting release was Final Rules: Filing And Disclosure Requirements Relating To Beneficial Ownership, SEC Release Nos. 33-5925 and 34-14692, 1978 WL 170898 (Apr. 21, 1978) ("Schedule 13G Adopting Release"). The current requirements are found in 17 C.F.R. § 240.13d-1(b)(1)(i). After the 1998 amendments discussed below, the passive investors eligible to file Schedule 13G are split into two groups. The first group is certain institutional investors, such as brokers, banks, investment companies, investment advisors and employee benefit plans. When they acquire a holding in the ordinary course of business that exceeds 5 % but does not exceed 10 % may file a Schedule 13G within 45 days after the calendar year in which the holding exceeds the lower threshold, and if the holding does exceed 10 % the Schedule 13G must be filed within 10 days after the calendar month in which the holding exceeds such threshold. 17 C.F.R. § 240.13d-1(b). This group must file an amended Schedule 13G during the first 45 days of each calendar year if there are any changes (17 C.F.R. § 240.13d-2(b)), and with 10 days after any change of at least 5 %. 17 C.F.R. § 240.13d-2(c). A separate, statutory exemption from § 13(d) filings is provided for purchases of securities in connection with an offering registered under the Securities Act. See § 13(d)(6)(A) Exchange Act.

150 Final Rule: Amendments to Beneficial Ownership Reporting Requirements, SEC Release No. 34-39538, 63 Fed. Reg. 2854, 2855 (Jan. 16, 1998) ("Schedule 13G Amending Release"). These "passive investors" now constitute the second group of investors that qualify to use Schedule 13G. The group is not limited to any particular type of person or entity, but may only use Schedule 13G if their holdings do not exceed 20 % of any class of equity. 17 C.F.R. § 240.13d-1(c)(3). If this threshold is crossed, such persons must within 10 days file a Schedule 13D. 17 C.F.R. § 240.13d-1(f)(1). This second group must make its initial filing on Schedule 13G within 10 days of exceeding the 5 % threshold (17 C.F.R. § 240.13d-1(c)), and must file an amended Schedule 13G during the first 45 days of each calendar year if there are any changes (17 C.F.R. § 240.13d-2(b)), and within 10 days of any change of at least 5 %. 17 C.F.R. § 240.13d-2(d).
• Submission of or solicitation of support for a shareholder proposal based upon investment policies regarding good corporate governance for all of the shareholder's portfolio companies, rather than to foster a control transaction for a particular company, indicates passivity;

• Submission of or solicitation of support for a shareholder proposal under facts and circumstances that are likely to have the effect of facilitating a change of control of that particular company (for example, submission of a proposal to eliminate a staggered board) would indicate disqualifying "activity";

• Submission – without independent solicitation for support – of a proposal would indicate passivity;

• Submission of or solicitation of support for a shareholder proposal against a proposal put forth by management would indicate disqualifying activity; and

• Merely voting in favor of a challenger's proposal or making a voting announcement in favor of a corporate governance proposal would not cause the loss of Schedule 13G eligibility.

This list is quite helpful for distinguishing between acceptable passivity and disqualifying activity as understood by the SEC. However, it sets a rather low bar, as actions like returning a board to its "non-staggered" state so that directors come up for election annually should hardly in all cases fall under the activity that the Williams Act is designed to prevent. Perhaps prompted by the slowly rising acceptance of shareholder voice described in Part V, the SEC asked five years later whether the possibility of triggering Schedule 13D reporting requirements currently had a chilling effect on shareholders who seek to conduct ordinary monitoring activity, such as organizing a campaign to withhold votes from an undesirable candidate for the board. This would seem to indicate that the definition of "disqualifying activity" is evolving.

2. Duties of Insiders under § 16 Exchange Act

A second set of restrictions imposed by the federal securities laws treats shareholders, directors and officers similarly. Section 16 Exchange Act applies both to "every person who is directly or indirectly the beneficial owner of more than 10 percent of any class of any equity security . . . registered pursuant to Section 12," and to every person "who is a director or an officer of the issuer of such security." This section, which was part of the original Exchange Act, requires the persons covered both to report their securities transactions to the SEC and to disgorge to the company any profits from purchases or sales in the company's securities made within a six-month period. Although the 10 % threshold triggering § 16 provides more leeway than the 5 % set in § 13 Exchange Act, reaching the threshold triggers an obligation to report holdings in all types of the issuer's

151 Schedule 13G Amending Release, Id. at 2859.


154 15 U.S.C.A. § 78p(a) and (b); See LOSS & SELIGMAN, supra note 15, at § 6-E-1, and THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 13 (5th ed., 2005).
securities held,\textsuperscript{155} not just the class in which the 10\% threshold was reached. Moreover, the concept of a "group" used for § 13(d) Exchange Act also applies to § 16 Exchange Act,\textsuperscript{156} and the judicially made concept of "deputization" can result in a shareholder being deemed a director of the issuer if it elects a director to the board.\textsuperscript{157} One can image that the duty of disgorgement could also be significantly more disrupting to a shareholder than a reporting requirement. It is typical of a fiduciary duty to require the fiduciary to disgorge profits she obtained from the resources subject to the fiduciary relationship.\textsuperscript{158} The impact of § 16 Exchange Act, like that of § 13 Exchange Act, is to discourage shareholders from building up holdings that could trigger the 10\% threshold.\textsuperscript{159} This is regretful, as the larger a shareholder's equity interest in a company, the more incentive such shareholder has to study company disclosures, responsibly exercise voting rights, and actively participate to ensure optimum company performance.\textsuperscript{160}

This brief discussion of the fiduciary duties and federal obligations of shareholders shows that the characterization of shareholders as unconstrained actors, reigned in by dutiful management, contains more polemic than truth. The following section shows the main reason why the fiduciary duties of shareholders are limited: shareholders almost never use their residual power as owners. Further, one need not examine the actual, empirical state of shareholders to see this weakness, for it has been designed into the default structures of American corporate law. The default governance structure offered by corporate law statutes such as the Delaware General Corporation Law and the Revised Model Business Corporation Act, in particular when working together with the federal proxy rules, deprive shareholders of express legal power to influence the corporation they own, except in the most extreme circumstances.

\textsuperscript{155} LOSS & SELIGMAN, \textit{supra} note 15, at § 6-E-2.

\textsuperscript{156} See HAZEN, \textit{supra} note 154, at § 13.3[2][B]. Morales v. Freund, 163 F.3d 793 (2\textsuperscript{nd} Cir. 1999).

\textsuperscript{157} See Feder v. Martin Marietta Corp., 406 F.2d 260 (2\textsuperscript{nd} Cir. 1969) and Blau v. Lehman, 368 U.S. 403 (1962). Both cases are discussed in LOSS & SELIGMAN, \textit{supra} note 15, at § 6-E-7.b and HAZEN, \textit{supra} note 145, at § 13.3[1][A].

\textsuperscript{158} "While the usual remedy in legal actions is money damages measured by reference to the harm incurred by the plaintiff, the remedy most often associated with a breach of fiduciary duty is disgorgement of profits. Disgorgement is measured by the amount of the fiduciary's gain rather than by the amount of the beneficiary's loss, implying that the primary goal of providing the remedy is deterrence." Smith, \textit{supra} note 93, at 1493.

\textsuperscript{159} See Coffee, \textit{Liquidity vs. Control}, \textit{supra} note 2, at 1343.

IV. SHAREHOLDER VOICE IN THE STATUTORY GOVERNANCE STRUCTURE

Discussion of weak shareholder voice usually focuses on the empirical condition of small shareholders in U.S. corporations: dispersed, uninformed and uninterested. As a result, intractable problems like the cost and complexity of decision-making and the rationality of apathetic inaction seemingly render shareholder voice an impractical governance instrument that gains utility only when transferred to a takeover bidder. Thus, much of the discussion of shareholder rights has addressed the right of shareholders to accept tender offers, and the extent to which management can block such offers. Less attention, it seems, has been given to the manner in which corporate statutes allocate power between shareholders and management. As discussed above, shareholders have residual power that allows them to alter and shape the governance structure of a stock corporation as they choose. However, this power is rarely used, and in a recent law review article, Prof. Lucian Arye Bebchuk has shed welcome light on how the default governance structures supplied by U.S. corporate statutes place shareholders in a weaker position than is generally understood. Prof. Bebchuk highlights the obvious yet overlooked fact that shareholders do not decide on fundamental corporate matters, but only have an occasional right to veto them. This places shareholders in the passive and negative position of either accepting management's domination or blocking activity altogether. When this thorough dependence on management is seen in combination with an election process that makes it very difficult for shareholders to either choose or oust management, the structurally determined weakness of shareholders becomes clear. This weakness, which stems from statutory default provisions and a practical difficulty in pushing through charter amendments to increase shareholder power, as well as from a detrimental interaction of state and federal law, is one reason why the opponents of shareholder voice argue that shareholders are not owners. Indeed, these impediments to shareholder power should be corrected if we do not intend to wake one day and find that a creeping,

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161 See CLARK, supra note 14, at 390-92. For an excellent discussion of the “empirical” condition of shareholders as well as of the constraints that federal law places on shareholder action, see Bernard S. Black, Shareholder Passivity Revisited, 89 Mich. L. Rev. 520 (1990).

162 See CLARK, supra note 14, at 398.


164 See supra note 55 and accompanying text.

165 See Bebchuk, Shareholder Power, supra note 21.

166 See infra note 173 and accompanying text.

167 “If ‘control’ is the economically important feature of ‘ownership,’ then to build a theory of corporations on the premise that ownership (and, hence, control) lies with shareholders grossly mischaracterizes the legal realities of most public corporations.” Blair & Stout, supra note 26, at 260.
historical development has "taken" the entire outstanding share capital of U.S. public corporations and placed it in the hands of a communal "team". 168

A. The Statutory Balance of Power between Shareholders and Management

Pursuant to § 141(a) of the Delaware General Corporation Law, a corporation is managed "by or under the direction of the board of directors." 169 This is no different under the Revised Model Business Corporation Act ("RMBCA"). 170 Both statutes provide that shareholders have a residual right to remove some or all of this power from the board in the corporate charter. 171 That this right is rarely used probably stems from a mixed bag of causes, including efficiency considerations and that most shareholders buy into corporations already established, 172 that statutes normally give the board an exclusive right to propose charter amendments in the annual meeting, 173 and that boards have no interest in making proposals to reduce their own power. 174 If the statutory default structure is not customized, shareholders are locked in an exclusively reactive position, as Prof. Lucian Bebchuk

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168 This paper does not argue that such a redistribution of ultimate entitlements from those with property rights to those who contribute other factors to the company is reprehensible. However, any such redistribution should be accomplished consciously, voluntarily and legally, rather than by a subtle, unseen process in which legal theorists slowly chisel away property rights. If partially incorrect and partially confusing assertions regarding shareholder property rights are made often enough by respected professionals in respected publications, one court, and then another, could eventually deem the property rights of shareholders nonexistent. We should remember that unfortunate, polemical distortions of property rights in the late 19th and early 20th centuries brought much unrest and unhappiness to significant parts of the globe. Physicists are not the only scholars whose work can lead to bombs.


170 § 8.01 RMBCA.

171 As discussed in Part II.A, the second sentence of § 141(a) allows the certificate of incorporation to specify that "the powers and duties conferred or imposed upon the board of directors by this chapter" shall be exercised "to such extent and by such person or persons as shall be provided in the certificate of incorporation." Del. Code Ann. tit. 8, § 141(a) (emphasis added). § 8.01 RMBCA provides: "All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section" (emphasis added). On the Delaware provision, Franklin Balotti and Jesse Finkelstein comment: "Use of the special provisions relating to close corporations is not the only example of arrangements which may be made to provide for a form of management other than that carried out by or under the direction of the board. Shareholders' agreements are commonplace in "regular" corporations (i.e., those not formed as close corporations) as well. Moreover, even in regular corporations the certificate could provide for special management measures. " R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 7.57 (2002).


173 Del. Code Ann. tit. 8, § 242(b)(1), and § 10.03 RMBCA.

174 If a number of possible amendments could be proposed, the proposal actually selected "will be very much influenced by which change would best serve management's interests." Bebchuk, Shareholder Power, supra note 21, at 862. For a detailed discussion of the power dynamics in making charter amendments and the board's reluctance to enact amendments that decrease their own power, see Lucian Arye Bebchuk, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 HARV. L. REV. 1820, 1820-25 (1989).
explains: "A central and well-settled principle of U.S. corporate law is that all major corporate decisions must be initiated by the board. Shareholders may not initiate any such decisions." Like being in an automobile with only brakes, but no steering wheel or accelerator, this veto power lends shareholders only a very imperfect influence on corporate affairs (aside from jumping out before the crash). As Prof. Bebchuck explains:

> Shareholders' veto power prevents the adoption of changes that would make shareholders worse off than they would be under the status quo. Veto power is thus a "negative" power that precludes any worsening of the shareholders' situation. This power, however, cannot ensure that rule changes that could increase shareholder value will take place. In particular, when management disfavors a value-increasing change for self-interested reasons, shareholders' veto power will not enable them to obtain this change.\(^{176}\)

The result is that for decisions on such major structural changes as mergers or consolidations,\(^{177}\) or sales, leases or exchanges of all or substantially all of the corporation's property and assets other than in the ordinary course of business,\(^{178}\) the board has sole authority to propose or exclude the matter from a shareholder vote,\(^{179}\) and, in the case of a sale, lease or exchange of assets under Delaware law, the board need not consummate the transaction even after the shareholders have voted to approve it.\(^{180}\) The default provisions of U.S. corporate law statutes also give the board almost unrestricted discretion on whether a primary economic right of the shareholders – the right to receive dividends – will be fulfilled in individual cases.\(^{181}\) This lack of shareholder authority creates significant agency problems by allowing directors to stockpile cash that they can use for unprofitable empire-building or otherwise misuse.\(^{182}\) It is doubtful that this moral hazard could be completely eliminated by shareholder introduction of a general policy on the distribution of dividends.

Given these circumstances and a growing need to exercise some influence over their investments, shareholders have resorted to a somewhat ragged assortment of improvisations in attempts to gain influence over, rather than simply exiting, their corporations. One type of available

\(^{175}\) Bebchuk, *Shareholder Power*, supra note 21, at 836.

\(^{176}\) Bebchuk, *Shareholder Power*, supra note 21, at 862.

\(^{177}\) See Del. Code Ann. tit. 8, § 251(c), and § 11.04(b) RMBCA.

\(^{178}\) See Del. Code Ann. tit. 8, § 271(a), and § 12.02 RMBCA. The board alone may sell or lease the corporation's assets in the ordinary course of business. § 12.01 RMBCA.

\(^{179}\) Bebchuk, *Shareholder Power*, supra note 21, at 889.

\(^{180}\) See Del. Code Ann. tit. 8, § 271(b).

\(^{181}\) See Del. Code Ann. tit. 8, § 170(a), and § 6.40(a) RMBCA. The Delaware Court of Chancery held, for example, in Leibert v. Grinnell Corp., 194 A.2d 846 (Del. Ch. 1963), that stockholders may not force directors to declare dividends even in the face of a large surplus and a charter provision emphasizing a corporate purpose to receive and distribute dividends.

\(^{182}\) See Bebchuk, *Shareholder Power*, supra note 21, at 903-906, citing numerous empirical studies that confirm a tendency of management to build empires with excess cash rather than distributing it to shareholders.
voice is indistinguishable from a mass exit. Although the dissolution of the corporation normally follows the standard procedure of board recommendation and shareholder vote,\textsuperscript{183} it is possible under Delaware law for shareholders acting unanimously to place a corporation into dissolution.\textsuperscript{184} Two other types of voice are second-best solutions. As shareholders may not themselves initiate a charter amendment in the shareholder meeting, they may attempt to achieve similar results by amending the hierarchically lower by-laws.\textsuperscript{185} Although it is debated just how far the by-laws can be stretched, given their nature and function, it is likely that their power is limited to forward looking, general rules that set up procedural requirements not in conflict with the law or the certificate of incorporation.\textsuperscript{186} Another way that shareholders have attempted to hammer their ploughshares into swords is by making mere recommendations, or "precatory" proposals to be included in proxy materials pursuant to Rule 14a-8 under the Exchange Act.\textsuperscript{187} Such proposals are often formulated as by-laws amendments and often seek to remove defences to takeovers or increase board independence.\textsuperscript{188} Boards routinely ignore such proposals, even when they address matters far from ordinary management, such dismantling staggered boards to ensure that the entire board will stand for election each year, and even when a

\textsuperscript{183} See Del. Code Ann. tit. 8, § 275(a), and § 14.02 RMBCA.

\textsuperscript{184} See Del. Code Ann. tit. 8, § 275(c).

\textsuperscript{185} See Del. Code Ann. tit. 8, § 109, and § 10.20 RMBCA. The Delaware provision is used in two additional states and the Model Act provision is used in 23 additional states. \textsc{Jonathan R. Macey}, \textit{Macey on Corporations}, 2002, § 3.06[B]. Delaware courts regard by-laws generally "as the proper place for self-imposed rules and regulations deemed expedient for [the corporation's] convenient functioning" as opposed to the certificate of incorporation, which "is an instrument in which the broad and general aspects of the corporate entity's existence and nature are defined." \textit{Gow v. Consolidated Coppermines Corp.}, 165 A. 136, 140 (Del. Ch. 1933).

\textsuperscript{186} See \textsc{John C. Coffee}, \textit{The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?}, 51 U. \textit{Miami L. Rev.} 605, 614 (1997).

\textsuperscript{187} 17 C.F.R. § 240.14a-8. Management may exclude a shareholder proposal from its proxy materials for a number of reasons, including when the proposal would be improper under state law because, for example, it conflicted with a statutory allocation of power. 17 C.F.R. § 240.14a-8(i)(1). \textit{In a note to this section, the SEC has explained: "Depending on the subject matter, some proposals are not considered proper under state law if they would be binding on the company if approved by shareholders. In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise."}

\textsuperscript{188} See Roberta Romano, \textit{Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance}, in \textit{Corporate Governance Regimes: Convergence and Diversity} 507 (Joseph A McCahery, et al., eds., 2002). The line separating acceptable proposals to enhance board independence from those that may be excluded under Rule 14a-8 is a fine one. For example, the SEC reports that it did not allow management to exclude a Rule 14a-8 proposal to amend the by-laws of General Motors Corp. to require "a transition to independent directors for each seat on the audit, compensation and nominating committees as openings occur." SEC Division of Corporation Finance, Staff Legal Bulletin No. 14, "Shareholder Proposals" 7 (July 13, 2001), available at \texttt{http://www.sec.gov/interp/legal.shtml}. \textit{In this way, shareholders were able to take measures against insider entrenched in the key committees of GM's board of directors. However, as a former head of the SEC Division of Corporate Finance reports, the SEC policy regarding exclusion is somewhat uncertain, See \textsc{Linda C. Quinn & Ottilie L. Jarmel}, \textit{The Shareholder Proposal Process}, in \textit{Practical Guide}, supra note 17, at 15-15 et. seq.}
proposal is adopted again and again by a majority of the shareholders. Managerialists are wont to call such recommendations "reform at gunpoint" stirred up by "activists." Given the central role of public investment in the U.S. economy and the professional calibre of the parties involved, it is saddening to see corporate governance at its highest level revolve around by-law provisions hopefully stretched to resemble charter rules and "recommendations" iterated in the hope of shaming management into action.

One instrument that perhaps has potential, although it still faces certain logistical limitations, is the written consent. Although the RMBCA requires unanimous action in all cases where consents are used, the Delaware General Corporation Law provides that, "any action required . . . to be taken at any annual or special meeting of stockholders . . . may be taken without a meeting . . . if a consent or consents in writing . . . shall be signed by the holders of outstanding stock having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting. . . ." Shareholders are free to solicit consents in complete independence of the board and without giving any requirement of prior notice. There are three statutory disadvantages to action by consents. First, the power to act by consents can be eliminated in the charter. Second, unless the action by consent fills "all of the directorships to which directors could be elected at an annual meeting" at the time of the consent, unanimous action is required to elect directors to the board. Third, the denominator used to calculate whether a required majority has been reached is "all shares entitled to vote" on the particular issue, which could well be higher than the normal denominator of shares present in person or by proxy at the meeting and entitled to vote on the relevant matter. However, it should be noted that this is comparable to the majority required at a meeting to approve mergers and asset sales. Aside from these limitations, "the statute creates a right in stockholders to act

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189 Prof. Bebchuk provides empirical evidence gathered by the Investor Responsibility Research Center showing that although resolutions to eliminate staggered boards were repeatedly adopted during the period between 1997 and 2003, boards refused to implement more than two-thirds of the resolutions adopted. Bebchuk, Shareholder Power, supra note 21, at 854.


191 See § 7.04(a) RMBCA.

192 Del. Code Ann. tit. 8, § 228(a).

193 Del. Code Ann. tit. 8, § 228(a). Because if directors seriously believed that, in spite of the logistical difficulties, written consents offered shareholders a realistic avenue to circumvent their monopoly over the decision-making process, they would likely propose to amend the charter to remove consents, the possibility of using consents should probably be a mandatory provision.

194 Del. Code Ann. tit. 8, § 211(b).

195 Del. Code Ann. tit. 8, § 228(a).


197 Del. Code Ann. tit. 8, § 251(c) requires approval by "majority of the outstanding stock of the corporation entitled to vote thereon" to approve a merger, and Del. Code Ann. tit. 8, § 271(a) requires approval by the same majority.
independently of the directors upon whom they might otherwise be dependent to call a meeting." 198 Thus, combined with the right of access to the list of stockholders for the purpose of communicating with them, 199 and the speed and cost-effectiveness of email consents, 200 it would seem that the use of consents would offer a powerful tool for shareholders to take some initiative. The drawback comes from market structure rather than corporate law. Because of the relatively old-fashioned way that shares are currently horded in the vaults of depositories, with entitlements to the shares filtered through the accounts of banks and brokers, it is extremely difficult and time consuming to find out who shareholders are and how to contact them, which would make efficient solicitation very difficult. 201 Moreover, although Delaware law has designed consents as a tool to assist quick shareholder action, the entire body of federal proxy rules applies to consents just as to proxies, which means that the solicitation of consents for registered companies must comply with the timing requirements and incur at least some of the costs of a proxy solicitation. 202 Consents do not yet appear to have become a tool that is commonly used to influence corporate governance.

Given the structural and practical hurdles placed in the way of shareholder action in U.S. corporations, much depends on the skill, loyalty and character of corporate directors. This greatly amplifies the importance of a shareholder’s right to elect directors. The following section discusses the exercise of this right, which is also much less than it might seem.

B. The Election of Directors

Since a corporation rests squarely in the control of its board of directors, the shareholders’ main avenue of influence would be to choose who sits on that board. The law tells us that directors appointed for full terms receive their seats on the board by shareholder vote. 203 This should mean that shareholders have significant influence on the composition of the board. Yet this "is largely a myth.

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200 Consents may be delivered by "electronic transmission." See Del. Code Ann. tit. 8, § 228(d)(1).
201 On the impediments created by the indirect holding system, see Loss & Seligman, supra note 15, at § 6-C-6 and Task Force on Shareholder Proposals of the Committee on Federal Regulation of Securities, Section of the 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, 117-17 (2003). Delaware courts have strictly required that record holders, as opposed to actual beneficial owners, sign written consents. See Welch & Turezyn, supra note 198, at § 228.4. Although the proxy rules created to assist procuring necessary authorizations from both record and beneficial shareholders (17 C.F.R. §§ 240.14a-13, 14b-1 and 14b-2) also apply to consents, the effectiveness of this system is, even in the case of proxy solicitations, questionable and costly.
203 See Del. Code Ann. tit. 8, § 211(b), and § 7.28(a) RMBCA.
Attempts to replace directors are extremely rare, even in firms that systematically under-perform over a long period of time. By and large, directors nominated by the company run unopposed and their election is thus guaranteed. The key for a director's re-election is remaining on the firm's slate.\textsuperscript{204} Access to the firm's slate of director candidates is, moreover, controlled by the board, and the presence of independent directors on a board nominating committee fails to provide comfort exactly in those cases when it is most needed: when shareholders mistrust the board and wish to appoint new members.\textsuperscript{205} The default mechanism for nominating candidates, while it is designed to encourage management to act wisely \textit{for} shareholders, effectively eliminates shareholder input, and the type of vote with which the candidates are elected ensures that whomever is nominated will be elected.

Unless the company's certificate of incorporation provides otherwise, directors are elected by a "plurality" of the votes present at a meeting.\textsuperscript{206} A "plurality" of the votes means the largest portion of votes cast.\textsuperscript{207} Current proxy regulations do not provide for alternative candidates to be listed for a given board position; the card allows the shareholder to either vote for management's candidate or "withhold" his vote for such position.\textsuperscript{208} This means that when no alternative candidate is available, which is the rule absent a proxy contest, any vote at all for the listed candidate constitutes a winning plurality. Prof. Joseph Grundfest provides a graphic illustration of the point: under a plurality rule, if "a million shares count as a quorum, and if 999,999 ballots strike your name out and say no, you, as the director, owning only one share, and you vote for yourself, congratulations, you win. You have the plurality."\textsuperscript{209} The effects of plurality voting creates a real need for alternative candidates on the ballot.

\textsuperscript{204} Bebchuk, \textit{Shareholder Access}, supra note 90, at 45 \textit{et seq.}, citing a study performed on proxy contests held by listed companies between 1996 and 2002, which showed that on an average only two contests were run each year for companies with market capitalization exceeding $ 200 million.

\textsuperscript{205} \textit{Id.}, at 49. The domination of the nomination process by incumbent management is well known and documented. \textit{See} C. \textit{Lark}, supra note 14, at 109 ("It is a notorious fact that in the over-whelming majority of elections for directorships in public corporations the public shareholders simply vote for whomever is proposed by the corporation's nominating committee. At least in the past . . . . Nominees tended to be agreeable, chummy persons, usually of the same social class as the incumbents. . . . This characterization frequently had to be qualified, however, when the corporation had a large shareholder whose director-representatives were really looking out for that shareholder's interest."); Task Force on Shareholder Proposals, supra note 44, at 118; \textit{Monks \& Minow}, supra note 21, at 212 \textit{et seq.}, and Leo E. Strine, Jr., \textit{Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle}, 57 BUS. LAW. 1371, 1377 (2002).

\textsuperscript{206} See Del. Code Ann. tit. 8, § 216, and § 7.28(a) RMBCA.

\textsuperscript{207} "Plurality. A large number or quantity that does not constitute a majority; a number greater than another, regardless of the margin . . . ." \textbf{BLACK'S LAW DICTIONARY} 1176 (7\textsuperscript{th} ed, 1999).

\textsuperscript{208} 17 C.F.R. § 240.14a-4(b)(2).

\textsuperscript{209} Remarks of Prof. Joseph Grundfest in "Symposium on Corporate Elections", 95 (Lucian Arye Bebchuk, ed., Nov. 2003), available at \url{http://ssrn.com/abstract=471640}. A recent ISS white paper reports that a task force of the American Bar Association and a working group of corporations and labor pension funds have been set up to study the possibility of introducing majority – as opposed to plurality – voting for the election of directors. \textbf{INSTITUTIONAL SHAREHOLDER SERVICES, MAJORITY VOTING IN DIRECTOR ELECTIONS: FROM THE SYMBOLIC TO THE DEMOCRATIC 1} (2005), available at \url{http://www.issproxy.com/governance/whitepapers.jsp}. 

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As the system currently stands, shareholders have no opportunity to contest the election of a management candidate unless they become a "dissident", and pay for the distribution of proxy materials for an alternative list of candidates.\textsuperscript{210}

The fault in the nomination system does not lie in state law. Delaware law allows shareholders to nominate candidates for election to the board either on the floor of the meeting itself,\textsuperscript{211} or through a nomination notice that is given to the board and distributed by the board to the other shareholders.\textsuperscript{212} Moreover, shareholders may use a campaign for written consents to propose and elect a new slate of directors.\textsuperscript{213} The primary restriction placed on the use of consents to nominate and elect directors is that a unanimous vote is required if less than all of the directors that could be elected at the meeting replaced by the consents are in fact elected.\textsuperscript{214} Thus Delaware law contains neither an express nor an implied policy against allowing shareholders to nominate candidates for the board of their company. However, once a Delaware corporation becomes subject to the registration requirements of § 12 Exchange Act, the rudimentary requirements of state law for the calling of a shareholders' meeting\textsuperscript{215} are preempted by the proxy rules issued under § 14 Exchange Act.\textsuperscript{216} For an annual meeting,

\textsuperscript{210} The argument is sometimes raised that the "withholding" of votes is by itself a "very potent weapon" against management. Remarks of Martin Lipton in Symposium on Corporate Elections, \textit{Id.} at 22. However, the strength of such message depends not on any binding nature of withholding the vote, but only on how management might interpret its effect on their reputations, which in turn depends on the current understanding of shareholder rights. The case of Walt Disney Co. presents a good example. At its 2004 shareholders' meeting, votes withheld from the much criticized Michael Eisner exceeded 42 % of votes cast, yet the only reaction was to replace him as chairman with one of his closest allies, and to announce that he would step down from his CEO position two years later, at the normal expiration of his contract in 2006. \textit{See \textit{INSTITUTIONAL SHAREHOLDER SERVICES}, 2004 POSTSEASON REPORT 5, available at http://www.issproxy.com/governance/issreports/index.jsp.} It appears that any reaction at all to a withhold campaign must be interpreted as a victory, but it certainly is not a "very potent weapon."

\textsuperscript{211} BALOTTI \& FINKELSTEIN, \textit{supra} note 171, at § 7.57.


\textsuperscript{213} \textit{See note 192 supra} and accompanying text, as well as Del. Code Ann. tit. 8, § 211(b), and BALOTTI \& FINKELSTEIN, \textit{supra} note 171, at § 7.31, citing Pabst Brewing Co. v. Jacobs, 549 F. Supp. 1068 (D. Del. 1982).

\textsuperscript{214} \textit{See Del. Code Ann. tit. 8, § 211(b).}

\textsuperscript{215} Pursuant to Delaware law, for example, the directors must call the annual meeting within a certain time frame (Del. Code Ann. tit. 8, § 211), and provide adequate notice of the meeting to the shareholders (Del. Code Ann. tit. 8, § 222(a)). Notice to an annual meeting need not specify the meeting's purpose if proxies are not solicited (Stroud v. Grace, 606 A.2d 75 (Del Supr., 1992)), but such specification is necessary where the meeting is called for a specific transaction. (Del. Code Ann. tit. 8, § 222(a)). Notice must be given at least 10 days before the meeting (Del. Code Ann. tit. 8, § 222(b)), but the date of the meeting cannot be used to disenfranchise shareholders. Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. Supr., 1971).

\textsuperscript{216} 17 C.F.R. §§ 240.14a-1 – 14a-15.
management must prepare a proxy statement on Schedule 14A,\textsuperscript{217} containing extensive information on
the company and the candidates, file it with the SEC, and provide it to any person from whom a proxy
is solicited.\textsuperscript{218} There is no provision to allow inclusion of shareholder nominations, even if such right
exists under state law. A proposal to allow some nominations by shareholders in certain situations,
briefly discussed below,\textsuperscript{219} would not significantly alter this situation.

Aside from hoping that the disclosure of nominating committee practices in Schedule 14A\textsuperscript{220} will
shame management into occasionally accepting a shareholder nominee, how can shareholders exercise
their right, existing under Delaware law, to nominate candidates of their choice? Rule 14a-8 would
seem to be a logical avenue, as it allows shareholders who meet specified holding requirements to
include a proposal and brief supporting statement in the company's proxy materials.\textsuperscript{221} This is especially true because the Rule was originally designed to "to assure to the stockholders . . . those
rights that he has traditionally had under State law."\textsuperscript{222} Nevertheless, one of the express grounds for
excluding a shareholder proposal under Rule 14-8 is if it relates to "election for membership on the
company's board of directors or analogous governing body."\textsuperscript{223} In this way, the state law right to
nominate a candidate for the board is frustrated by a federal law requirement that excludes such a
nomination from the primary document through which it realistically could be made. As Prof. Jill
Fisch explained in 1993:

In spite of congressional concern in 1934 that corporate insiders controlled the election
process, a concern to which the proxy regulations appear to be addressed, insider
domination of the election process remains pervasive today. The continued ability of
corporate insiders to control director elections can be attributed, in part, to deficiencies in
the federal proxy rules. The proxy rules both have failed to provide affirmative access for
shareholders to participate in the nomination process and have thwarted shareholder
attempts at participation."\textsuperscript{224}

\begin{flushright}

218 17 C.F.R. § 240.14a-3(a).

219 See Part V.

220 See 17 C.F.R. § 240.101, Item 7. Disclosure requirements regarding the nominating committee are
discussed in Part V.B.8, infra.

221 In order to qualify to submit a proposal, a shareholder must "have continuously held at least $2,000 in
market value, or 1%, of the company’s securities entitled to be voted on the proposal at the meeing for
at least one year by the date" it submits the proposal, and continue to hold such securities through the
date of the meeting. 17 C.F.R. 240.14a-8(b)(1).

222 Remarks of SEC Chairman Ganson Purcell, Security and Exchange Commission Proxy Rules,
Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 before the House Committee on Interstate and
Foreign Commerce, 78th Cong., 1st Sess. 172 (1943), quoted and discussed in Jill E. Fisch, \textit{From

223 17 C.F.R. 240.14a-8(i)(8).

224 Fisch, supra note 222, at 1162-63.

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This leaves shareholders who desire to nominate a candidate for election to the board with few options prior to the meeting: they can either seek "informal" contact with the board, relying on its generous cooperation,\(^{225}\) or launch a proxy contest in which they pay both for the printing and distribution of their own proxy materials and bear a portion of the impact of their opponents' spending on efforts against them (which will be funded by the corporation whose shares they hold).\(^{226}\) Such contests are rarely conducted to replace management outside of the takeover context.\(^{227}\) Proxy contests also present a "public good" problem because they are financed by a single shareholder or group of shareholders, yet benefit all shareholders, thereby forcing the active shareholder to become the benefactor of all other, "free riding" shareholders.\(^{228}\) Reimbursement of a challenger's costs is possible, but the law on the question displays a troublesome twist. A challenger may be reimbursed for a contest run for "policy" questions as opposed to one merely seeking to oust the board,\(^{229}\) but the challenger may not vote itself reimbursement unless it does in fact oust the board.\(^{230}\) Providing access to the company's proxy machinery would reduce these costs for the active shareholder,\(^{231}\) but the management lobby fiercely defends the status quo.\(^{232}\) The result, as the Vice Chancellor of the Delaware Court of Chancery, Leo Strine, has noted in a law review article, is that the "proxy mechanism is tilted heavily in favour of the management slate,"\(^{233}\) which of course raises questions about "a corporate election process that is so heavily biased towards incumbents and their self-chosen

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\(^{225}\) Messrs Lipton and Rosenblum stress the virtues of informal collaboration as opposed to shareholder entitlement. See Lipton & Rosenblum, supra note 28, at 84. Any "voluntary" or "informal" cooperation that takes place in any kind of negotiations for anything of value always take place against the background of the legal rights of each party. This is just as true for corporate governance as for settlement negotiations in the litigation context. Indeed, while the threat of adopting a rule to allow shareholders to nominate a limited number of candidates for the board was being considered, the "voluntary" cooperation of management in such negotiations skyrocketed. See INSTITUTIONAL SHAREHOLDER SERVICES, supra note 210, at 5.

\(^{226}\) See LOSS & SELIGMAN, supra note 15, at § 6-C-1.

\(^{227}\) In a study of proxy contests conducted by all listed companies between 1996 and 2002, in the companies studied over a period of seven years, only 80 companies experienced proxy contests to replace management outside of the takeover context. See Bebchuk, Shareholder Access, supra note 90, at 45-46.

\(^{228}\) Bebchuk, Shareholder Access, supra note 90, at 45; also see Robert C. Pozen, Institutional Perspective on Shareholder Nominations of Corporate Directors, 59 BUS. LAW. 95, 99 (2003).

\(^{229}\) Hall v. Trans-Lux Daylight Picture Screen Corp., 171 A. 226, 227 (Del. Ch. 1934).

\(^{230}\) See Steinberg v. Adams, 90 F. Supp. 604 (S.D. NY, 1950), where Judge Rifkind happily overcame the "policy" / "personnel" divide by observing: "The simple fact, of course, is that generally policy and personnel do not exist in separate compartments. A change in personnel is sometimes indispensable to a change of policy. A new board may be the symbol of the shift in policy as well as the means of obtaining it." 90 F. Supp. at 608.


\(^{233}\) Strine, supra note 8, at 1377.
successors."  This frustration of the shareholder franchise is particularly disturbing when one considers that such franchise is supposed to be "the ideological underpinning upon which the legitimacy of directorial power rests."  

The trends of ownership and rules controlling shareholder voice seem to indicate, however, that this situation will not endure forever. As shareholder sophistication has increased in recent decades, the law has gradually adapted to the changing circumstances. The following section briefly sketches some of these developments.

VI. THE GRADUAL RETURN OF SHAREHOLDER VOICE

A. An Increase in Institutional Investors

The picture presented by Professors Adolf Berle and Gardiner Means in 1932, of dispersed, isolated, and uninterested shareholders has gradually given way to a market structure in which the majority of investors are well-organized professionals. As Prof. Melvin Eisenberg pointed out more than thirty years ago, and as the business and academic communities widely discussed in the 1990s, the American public increasingly invests through intermediaries, so that financial institutions like pension and mutual funds are becoming the primary shareholders on the U.S. markets. That financial institutions may play a larger role in some other markets, such as in Germany, does not negate the changes that have taken place in the U.S. economy. The following table shows the holdings of institutions in U.S. corporate equities between 1960 and 2004:

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234 Id., at 1397.
236 Berle & Means, supra note 36, at 8.
237 "The short of the matter is that at the present time one-third of the stock in corporations listed on the New York Stock Exchange is held by highly sophisticated investors . . . ." Melvin A. Eisenberg, The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking, 57 Cal. L. Rev. 1, 53 (1969).
238 See e.g., Back, Passivity, supra note 161, at 567-69; Black, Agents Watching Agents, supra note 2, at 827-29, and Coffee, Half-Time Report, supra note 18, at 847-49.
### End of period, U.S. dollars in billions

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Private pension funds</td>
<td>16.5</td>
<td>67.1</td>
<td>605.9</td>
<td>1915.0</td>
<td>1,690.0</td>
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<td>State &amp; local pension funds</td>
<td>0.6</td>
<td>10.1</td>
<td>284.6</td>
<td>1,223.1</td>
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<td>Federal pension funds</td>
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<td>0.3</td>
<td>56.6</td>
<td>99.3</td>
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<td>Life insurance companies</td>
<td>5.0</td>
<td>14.6</td>
<td>81.9</td>
<td>891.9</td>
<td>1091.5</td>
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<td>Other insurance companies</td>
<td>7.5</td>
<td>13.2</td>
<td>79.9</td>
<td>194.3</td>
<td>209.0</td>
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<td>Bank personal trusts</td>
<td>0.0</td>
<td>87.9</td>
<td>190.1</td>
<td>356.8</td>
<td>223.4</td>
</tr>
<tr>
<td>Mutual funds</td>
<td>14.8</td>
<td>39.7</td>
<td>233.2</td>
<td>3,227.3</td>
<td>3697.2</td>
</tr>
<tr>
<td>Closed-end funds</td>
<td>5.0</td>
<td>4.3</td>
<td>16.2</td>
<td>36.6</td>
<td>81.4</td>
</tr>
<tr>
<td>Exchange-traded funds</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>65.6</td>
<td>217.7</td>
</tr>
<tr>
<td>Foreign sector</td>
<td>9.3</td>
<td>27.2</td>
<td>243.8</td>
<td>1,643.2</td>
<td>1906.1</td>
</tr>
<tr>
<td>Total equity held by U.S. institutions</td>
<td>58.7</td>
<td>264.1</td>
<td>1,735.0</td>
<td>9,610.4</td>
<td>10,420.3</td>
</tr>
<tr>
<td>Brokers and dealers</td>
<td>0.5</td>
<td>2.0</td>
<td>9.6</td>
<td>77.2</td>
<td>125.3</td>
</tr>
<tr>
<td>Commercial and savings banks</td>
<td>1.3</td>
<td>2.9</td>
<td>11.0</td>
<td>36.1</td>
<td>48.0</td>
</tr>
<tr>
<td>State and local governments</td>
<td>0.0</td>
<td>0.0</td>
<td>4.8</td>
<td>97.1</td>
<td>89.1</td>
</tr>
<tr>
<td>Households &amp; nonprofit organizations</td>
<td>359.8</td>
<td>562.3</td>
<td>1,770.1</td>
<td>7,806.2</td>
<td>6521.6</td>
</tr>
<tr>
<td>Total equities outstanding</td>
<td>420.3</td>
<td>831.2</td>
<td>3,531.3</td>
<td>17,627.0</td>
<td>17,204.4</td>
</tr>
<tr>
<td>% of total equity held by U.S. institutions</td>
<td>13.9%</td>
<td>31.8%</td>
<td>49.1%</td>
<td>54.5%</td>
<td>60.6%</td>
</tr>
<tr>
<td>% of total equity held by households &amp; nonprofit organizations</td>
<td>85.6%</td>
<td>67.6%</td>
<td>41.4%</td>
<td>44.3%</td>
<td>37.9%</td>
</tr>
</tbody>
</table>

Source: Federal Reserve Board, "Flow of Fund Accounts of the United States"

From this, we see that the percentage of total equity held by U.S. institutions increased from 13.9% about the time that Dean Manning expressed his opinions in 1958 regarding "the faceless mass of small stockholders," to 31.8% shortly after Prof. Eisenberg first flagged the growing concentration of equity ownership in 1969, to 49.1% about the time that the academic literature began to focus significant attention on the phenomenon in the early 1990s. During the same period, the holdings of

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241 **BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS, 1955-1964, 1965-1974, 1985-1994, 1995-2004 page 82, Corporate Equities (Mar. 10, 2005), available at [http://www.federalreserve.gov/releases/z1/Current/data.htm](http://www.federalreserve.gov/releases/z1/Current/data.htm).** The Federal Reserve figures do not provide a breakdown showing the amount of corporate equities that commercials banks, savings banks and brokers manage rather than simply hold (with voting rights passed through to their customers). Excluding these groups from the category of institutional investors for purposes of this table shows a lower percentage of holding for institutions than a more accurate breakdown might yield. If the categories of commercial and savings banks and brokers and dealers were counted as "institutions" for 2004, the percentage of institutional holdings would be the slightly higher figure of 61.6%. On the other hand, a significant percentage of the "bank personal trusts" may pass through the voting rights of the shares held in trust to the trust beneficiary, which would render proxy voting decisions more "individual" than "institutional".

242 See Manning, *supra* note 27, at 1489.

243 See Eisenberg, *supra* note 237.

244 Prof. John Coffee, using the then current terminology of Thomas Kuhn, aptly referred to this swing of attention toward institutions as a "paradigm shift": "While the old paradigm saw the structure of the corporation as the product of a Darwinian competition in which the most efficient design emerged victorious, this new perspective sees political forces as constraining that evolutionary process and possibly foreclosing the adoption of a superior organizational form. Thus, my colleague Professor Mark Roe has argued that the Berle/Means corporation, in which ownership and control are separated, was not 'an inevitably natural consequence' of the economic and technological forces that shaped modern capitalism, but rather was an adaptation to political forces that limited the scale, scope, and power of financial institutions. Absent these politically imposed constraints, he suggests, the evolution of the modern corporation might have resulted in the emergence of a very different dominant organizational
households (and non-profit organizations)\textsuperscript{245} dropped from 85.5\% to 44.3\%. At the end of fiscal year 2004, the holdings of institutions stood at 60.6\% and those of households stood at 37.9\%. This is a very significant reversal over the period.

This gradual shift towards a market structure in which shareholders have the skills and organization to exercise voice on questions of corporate policy and governance has, as discussed in the previous section, not yet brought about significant changes in the actual, legal influence they exercise.\textsuperscript{246} However, during this period, shareholders have gradually returned to at least striking range of influence, and it looks something like the second half of a "fall and rise" of shareholder voice in the 20\textsuperscript{th} century. Prof. Jill Fisch described the first half (the "fall") as follows:

The role of the shareholder as an owner of the corporation underwent a dramatic change in the first half of the twentieth century. Although shareholders originally had ultimate authority to control the corporation, this power was taken from them through a variety of means, such as disappearance of the common-law right of shareholders to remove directors at will, reduction of the number of transactions that required unanimous shareholder approval, increased judicial deference to directors' business judgment and a refusal to permit shareholder challenges to the exercise of that judgment, and a growing view that shareholders had more or less permanently delegated managerial power over the corporation and could not exercise such power directly. . . . The disempowerment of the shareholder may have contributed to the abuses that predated the stock market crash of 1929. In assessing the abuses to which federal regulation should be addressed, Congress identified the ability of corporate insiders to use their power to take advantage of investors as a primary problem. Some of these practices became the explicit target of the federal legislation.\textsuperscript{247}

This legislation – primarily the Securities Act and the Exchange Act – took steps toward reinstating investors in a position of influence by giving them information in the contexts of public offerings, annual meetings and at regular intervals. An extensive body of case law has grown up around these rules on civil liability for faulty disclosure and outright fraud. Nevertheless, the movement of shareholders toward a return to real influence has been gradual and in patches faltering. As discussed in Part IV, state corporate statues, which in principle give shareholders complete control through charter amendments, in practice leave shareholders essentially powerless, especially when combined with the federal proxy rules. One reason for the very slow return of voice has been the

\textsuperscript{245} According to the Board of Governors of the Federal Reserve System, non-profit organizations make up about 6\% of the total given for this category. See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, GUIDE TO THE FLOW OF FUNDS ACCOUNTS, VOLUME 2 Table F-100, available at http://www.federalreserve.gov/releases/z1/fofguide.pdf.

\textsuperscript{246} Prof. John Coffee has provided an excellent analysis of many reasons why institutional investors do not engage more aggressively in monitoring, such as the differing needs and horizons of different institutional investors, the nature of fund manager contracts, and the market's view of activism. See Coffee, \textit{Half-Time Report}, supra note 18, at 843-71.

\textsuperscript{247} Fisch, \textit{supra} note 222, at 1137-38.
market's preference for shareholder "exit" over "voice" (shareholder monitoring), which is usually referred to as the work of "activists".

In 1994, Prof Coffee summed up the practical perspective of a fund manager that had angered a client by failing to exercise voting rights: "Better to lose an existing client, it may feel, than to acquire an activist reputation that deters dozens of potential clients." This would indicate that an increase in the market's acceptance of shareholder voice could reduce a significant deterrent to its practice; if the gadfly stigma were turned into a sign of muscular responsibility, voice would no longer deter potential clients, but rather attract them. Although the problem of free riding competitors still remains, ten years after Prof. Coffee's observation, The Wall Street Journal reported: "Calpers soon will issue its 2004 list of underachievers and, if past performances serves as any guide, it could contain some big 'buy' signals for investors." "Calpers", the California Public Employees' Retirement System, annually publishes a "focus list" of those portfolio companies that they consider to be underperforming, and on which they plan to focus attention – normally regarding corporate governance mechanisms or executive compensation – in the shareholders' meeting. Because the utility of a corporate governance mechanism may not differ substantially in comparable companies, institutions like Calpers can reap savings on evaluating the implementation of such measures through economies of scale, and it will be the cost and the effectiveness of voice itself that will determine whether they will take corrective action. The availability and effectiveness of mechanisms for shareholder voice will greatly affect this cost-benefit calculus. The steadily growing concentration of voting power in the hands of institutions has created pressure for reforming the tools of shareholder voice. This historical trend appears also to be tied to a subtle shift away from the tools that best serve small, private shareholders and an occasional raider, such as litigation and takeovers, and towards corporate "political" mechanisms that emphasize voice.

248 Id. at 863.
251 The Private Securities Litigation Reform Act of 1995 (Pub. L. No. 104-67) was promulgated to reduce the number of abusive law suits filed against heavily capitalized persons to seek compensation for losses from bad investments and raised the hurdles for plaintiffs in a securities fraud action. Although it is highly doubtful that the Court was reacting to this trend, the Supreme Court's decision in Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 128 L.Ed 2d 119 (1994), read the language of § 10 Exchange Act as restricting actions for securities fraud to primary actors who themselves commit fraud, thereby eliminating actions for aiding and abetting. This also reduced the reach of shareholder litigation. Neither of these changes was reversed by the Sarbanes-Oxley Act of 2002. As between small and large shareholders, however, the suit for a breach of fiduciary duty, discussed in Part III.A, remains to safeguard against breaches of duty among joint owners.
B. Reforms That Are Slowly Making Voice Viable

1. Ensuring the Distribution of Proxy Materials

Before shareholders can exercise voting rights, they have to know that a meeting is being held. As many shareholders are beneficial owners whose brokers, banks or central depositories are entered as holder of record in the stockholder register, and who are thus unknown to the corporation, simply sending information regarding the annual meeting is a challenge. The 1963 case of *Walsh and Levine v. Peoria and Eastern Railway Company*\(^{254}\) exemplifies why it was necessary to put some crude mechanisms in place to help proxy disclosures reach shareholders. Challengers launched a proxy contest, sent one copy of proxy materials to each name they found on the stockholder list, and trusted brokers – according to a supposed "custom" in the brokerage community – to notify them if more copies of the materials were necessary to allow beneficial owners to vote.\(^{255}\) While some brokers asked for additional copies for their customers, others did not and some simply voted their customers’ shares for management.\(^{256}\) Following the hesitating and drawn out process of discussion, study and debate that would become typical for attempts to facilitate shareholder voice,\(^{257}\) the SEC issued Rule 14b-1 to ensure that brokers would act as intermediaries to deliver proxy materials to the shareholders who held shares through accounts with them,\(^{258}\) and then, following enabling legislation from Congress,\(^{259}\) the

\(^{252}\) Statues and court decisions effectively halted the takeover wave of the 1980’s. As Prof. Coffee observes: "The rate of takeovers and other acquisitions has declined significantly and continues to decline. During the first quarter of 1991, merger and acquisition activity declined 18% over the corresponding quarter in the preceding year and hit an eleven year low. See Mergers at an 11-year Low, N.Y. TIMES, Apr. 18, 1991, at D10. The reasons for this decline are various: The drying up of the junk bond market; restrictive state antitakeover legislation, see infra note 5 and accompanying text, and judicial decisions that have accepted preemptive defensive tactics by target management. See, e.g., Paramount Communications Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989). This decline in takeover activity, particularly as a result of restrictive state legislation, has supplied the impetus, in my judgment, for scholars to consider the thesis that politics, more than economics, shaped the modern American corporation." Coffee, *Liquidity vs. Control*, supra note 2, at 1277, n. 1.

\(^{253}\) For a discussion of shareholder voting and the use of proxy contests as a "political" model opposed to the "transaction" model of the market for corporate control, see Pound, supra note 21.


\(^{255}\) 222 F.Supp. at 517-18.

\(^{256}\) 222 F.Supp. 518.


SEC then issued an almost identical Rule 14b-2 imposing a similar duty on banks. 260 Now, a series of interlinking duties allow – albeit clumsily – proxy information and voting instructions to navigate their way through the pyramid structure of bank and broker holdings by requiring (i) an issuer to seek out numbers of beneficial owners from depositories and their participating banks and brokers, 261 and (ii) requiring both brokers and banks to supply accurate numbers and then forward materials received from the issuer. 262

2. Softening the Overbroad Impact of Williams Act Rules

As discussed above, the duty to file a Schedule 13D upon crossing the 5% threshold singly or as part of a "group" both presents a significant obstacle to shareholder monitoring and does not always serve the legislative purpose of the Williams Act. 263 In 1978, 264 the SEC issued the significantly less intrusive Schedule 13G to allow institutional investors that "passively" invest in portfolio companies to file a significantly shorter form that was due originally and in updated forms within a much less pressing timeframe. In 1989, the SEC proposed expanding the types of investors that would be eligible to use Schedule 13G to include, "[i]n addition to the two current categories of Schedule 13G filers (institutional investors and persons reporting exempt acquisitions), a third category (passive non-institutional investors)." 265 As is typical for measures attempting to facilitate shareholder voice, adoption was a long, halting process. The amendments originally proposed in 1989 were put on ice,

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261 The duty of inquiry is imposed on registered issuers by Rule 14a-13, 17 C.F.R. § 240.14a-13, and the duty of depositories to provide a breakdown of participants who have the issuer's securities in their accounts is imposed by Rule 17Ad-8(b), 17 C.F.R. § 240.17Ad–8(b).

262 The relevant duty is imposed on brokers by Rule 14b-1, § 240.14b–1, which requires brokers or dealers to provide an issuer upon request with an accurate number of copies of proxy materials needed, and in a timely manner forward the proxy materials to their customer shareholders), and an almost identical duty is imposed on banks by Rule 14b-2, § 240.14b-2, with the exception that banks must also provide the issuer with prompt notice if they hold for correspondent banks, together with contact details for such banks. Rules 14b-1 and -2 also allow brokers and banks to provide issuers with a list of the names and addresses of customers who do not object to having their names disclosed, but issuers may use this list only for distributing annual reports, not for proxy materials.

263 See Part III.B.1.

264 See Schedule 13G Adopting Release, supra note 149.

then re-proposed in 1996 and adopted only two years later in 1998. As discussed in Part III.B.1 of this paper, work is still necessary to ensure that the definitions of the type of "group" that will trigger a disclosure obligation and the type of "disqualifying activity" that would prevent a shareholder from filing a Schedule 13G are not so broad as to frustrate and chill valuable shareholder monitoring.

3. Requiring Prudent Exercise of Voting Rights

With a growing presence of institutional share ownership, conflicts of interest between an institution's exercise of the votes from its beneficiaries' shares and its other business dealings with portfolio companies intensified. In its 1971 study of institutional investors, the SEC found that many preferred to support management or quietly exit rather than exercise meddling voice, and this tendency became known as the "Wall Street Rule." Few economic or legal incentives existed to counter this tendency. As ERISA Administrator of the U.S. Department of Labor (DOL) in the 1980's Robert Monks advocated the position that "casting a ballot . . . with an eye toward one's banking relationships rather than to the intrinsic merits of the measure, clearly violates ERISA." A report by Institutional Shareholder Services Inc. (ISS), which Mr. Monks established in 1984, found that portfolio companies could place institutions under pressure to support management policies in part because "the current regulatory structure gives investment managers no incentives to vote independently." In 1988, the DOL issued a letter to Board Avon Products, Inc., explaining its position that because "the decision as to how proxies should be voted . . . are fiduciary acts of plan asset management," voting decisions fall under the requirement in § 404(a)(1) ERISA "that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the

267 See Schedule 13G Amending Release, supra note 150.
269 The "Institutional Investor Study Report" described the "Wall Street rule" as follows: "[I]nstitutions tend to vote with management on questions put to a shareholder vote and . . . if they lose confidence in management they tend to sell their holdings in a company rather than to attempt to control or influence management decisions. This conclusion appears attributable to two factors. First, institutions are inclined to believe that their responsibility is to make investment decisions rather than to attempt to influence management decisions. Second, while there are no statutory restrictions upon the right of institutions to attempt to influence management decisions, institutions tend to believe that an effort to do so would be inappropriate and would subject them to criticism. . . . In general, it can be concluded that even where institutions have the potential power to influence management decisions they tend to be reluctant to exercise this power, particularly in an open and public way." Quoted in HEARD & SHEARMAN, Id. at 40.
272 See HEARD & SHERMAN, supra note 268, at 32.
273 Quoted in HEARD & SHERMAN, supra note 268, at 49.
exclusive purpose of providing benefits to participants and beneficiaries.” In 1994, the DOL codified this duty for application to all plans (i.e., private pension funds) subject to ERISA. \textsuperscript{274} This extension of fiduciary duty to the exercise voting rights encourages institutional investors to advocate the interests of their beneficiaries though voting rights despite threatened reprisals from the management of the portfolio companies. This duty is reinforced by a requirement that the trustee, or investment manager, as the case may be, formulate a "statement of proxy voting policy" and maintain written records of its votes cast. \textsuperscript{276} The DOL Interpretive Bulletin also explicitly condones "active" shareholder monitoring. \textsuperscript{277} Although ERISA does not apply to shareholders other than private pension funds, many state governments followed the DOL's lead in providing similar duties for state and local pension funds. \textsuperscript{278} In 2003, the SEC issued rules to require investment companies to publish their voting policies and their voting records, \textsuperscript{279} and to require investment advisers to adopt written policies and procedures designed to ensure that client securities are voted in the best interest of clients, provide clients with information on such policies and procedures, and upon request inform them of how votes were actually cast. \textsuperscript{280} In this way, during a period of about two decades, duties have been applied to most institutional investors on the U.S. market to either directly require or indirectly encourage them to exercise their voting rights according to a prudent business policy in the best interests of their beneficiaries.

4. Creating Independent Proxy Advice Organizations

Another step that has been crucial in the rise of shareholder voice was an initial reduction of collective action costs. Nonaffiliated organizations have sprung up in recent decades to analyze corporate governance mechanisms and the performance and proxy materials of listed companies, and then make their findings available to their clients or to the market as a whole. One such proxy advice organization is ISS, which describes its "core business" as "analyzing proxies and issuing informed


\textsuperscript{275} DOL Interpretive bulletin relating to written statements of investment policy, including proxy voting policy or guidelines, 29 C.F.R. § 2509.94–2 (2004).

\textsuperscript{276} \textit{Id.}, at (1) Proxy Voting and (2) Statements of Investment Policy.

\textsuperscript{277} \textit{Id.}, at (3) Shareholder Activism. This section provides: "An investment policy that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is consistent with a fiduciary’s obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan’s investment in the corporation, after taking into account the costs involved."

\textsuperscript{278} THOMAS & DIXON, supra note 16, at § 1.01[C].


research and objective vote recommendations for more than 28,000 companies across 115 markets worldwide."\(^{281}\) Another is the Investor Responsibility Research Center (IRRC), which describes its activities as "proxy research and analysis, benchmarking products, as well as proxy voting services to more than 500 institutional investors, corporations, law firms, foundations, academics and other organizations."\(^{282}\) These organizations spread many of the costs of shareholder monitoring widely throughout the market, thus reducing collective action problems, such as the free riding, that impede active monitoring. They can also serve as shields for publicity shy shareholders by taking much of the political "heat" for active monitoring.\(^{283}\) Large, public funds, like Calpers also provide a similar public good to the market.\(^{284}\) Recalling the analogy to political democracy, these institutions gather, digest and publish information and opinions on information much like the media does for citizens who have neither the time nor the means to visit state and national legislatures and analyze the raw data they need to make their voting decisions. Of course, like the media, these organizations are sometimes criticized for being too influential.\(^{285}\) It might be expected that the market will provide various types of proxy advice organizations to match variations in viewpoints among investors. The arrival of the internet in the mid-1990's further facilitated the publication of information and opinions on shareholder action and lowered the costs of communication between shareholders. The SEC reacted to these developments with admirable speed by issuing interpretive guidance in 1995 that embraced the electronic delivery of required communications.\(^{286}\)

5. Allowing Reasonable Shareholder Communications

The ability of proxy advice organizations to publish information and recommendations in connection with the exercise of voting rights was greatly facilitated by changes to the proxy rules made in 1992.\(^{287}\) These amendments are noteworthy because they were sought and obtained by the growing shareholders lobby,\(^{288}\) despite a furious battle by management to prevent their adoption.\(^{289}\) The

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282 See INVESTOR RESPONSIBILITY RESEARCH CENTER, at http://www.irrc.org/.

283 See Coffee, Liquidity vs. Control, supra note 2, at

284 See supra note 249, and accompanying text.

285 See the Steven A. Rosenblum's criticism of the influence wielded by ISS, cited in supra note 17.


289 Prof. Coffee phrased it thus: "Nothing that the [SEC] has done in recent years has been as controversial or significant as its efforts to reform the proxy rules to permit greater communication among shareholders. . . ." Coffee, Half-Time Report, supra note 18, at 837. Prof. Fisch described the adoption of the amendments as follows: "On October 16, 1992, after a comprehensive review of its system of proxy regulation and after two separate amendment proposals that drew more than 1700 letters of
amendments carved out an exclusion from the broad definition of regulated proxy "solicitation,"\textsuperscript{290} which had chilled communications among shareholders,\textsuperscript{291} to allow a shareholder to publicly announcements how he intends to vote and why.\textsuperscript{292} This exclusion, combined with the advent of the internet, helped to significantly reduce shareholder isolation. An exemption from the category of proxy solicitation was made also to allow free discussion with shareholders on issues related to voting, provided no proxy authority is sought, there is no substantial interest in the matter subject to vote, and the person initiating the discussion does not have a disqualifying characteristic (such as having to file a Schedule 13D).\textsuperscript{293} Other amendments reduced the time and resources necessary for conducting proxy solicitations subject to filing with the SEC.\textsuperscript{294} The requirements for the proxy form were changed to prevent management from linking together proposals against shareholders' interests (such as a by-law amendment limiting shareholder rights) with a "sweetener" (such as an extraordinary distribution of cash to shareholders);\textsuperscript{295} now each proposal must be separately listed.\textsuperscript{296} It was also made possible for challenging shareholders who launch a proxy contest to "round out" their ballot with consenting management directors, provided that the names of the management directors do not appear on the challenger's form of proxy.\textsuperscript{297}

6. The Unhappy Path of Rule 14a-8

The evolution of Rule 14a-8 since its inception in 1943 has been less encouraging. As Prof. Fisch explains in her historical analysis of the Rule, the SEC originally intended it simply to implement the rights that shareholders enjoyed under state law.\textsuperscript{298} However, as a lack of clearly articulated state

\begin{itemize}
\item \textsuperscript{290}See 17 C.F.R. § 240.14a-1(l) for the current definition of solicitation.
\item \textsuperscript{291}See THOMAS & DIXON, supra note 16, at § 1.01[E]; LOSS & SELIGMAN, supra note 15, at § 6-C-2.b. The SEC explained: "The amendments eliminate unnecessary regulatory obstacles to the exchange of views and opinions by shareholders and others concerning management performance and initiatives presented for a vote of shareholders." Shareholder Communications Release, supra note 286, at 48276.
\item \textsuperscript{292}17 C.F.R. § 240.14a-1(l)(2)(iv). See Shareholder Communications Release, supra note 286, Introduction.
\item \textsuperscript{293}17 C.F.R. § 240.14a-2(b). See Shareholder Communications Release, supra note 286, at II.A1.
\item \textsuperscript{294}Rule 14a-3 was amended to allow proxies to be solicited by public broadcast, speech or publication without delivering a proxy statement to the audience, provided a definitive proxy statement is on file with the SEC. Rules 14a-3(a) and 14a-4 were amended to allow proxy solicitation to commence on the basis of a preliminary proxy statement filed with the SEC, as long as a form of proxy is not provided until the definitive proxy statement is delivered. Rule 14a-6 was amended to allow solicitation materials other than the proxy statement and form of proxy to be filed with the Commission in definitive form at the time of dissemination. See Shareholder Communications Release, supra note 286, at II.C and D.
\item \textsuperscript{295}See Coffee, supra note 2, at 1327.
\item \textsuperscript{296}17 C.F.R. § 240.14a-4(a), (b)(1). See Shareholder Communications Release, supra note 286, at II.H.
\item \textsuperscript{297}17 C.F.R. § 240.14a-4(d). See Shareholder Communications Release, supra note 286, at II.I.
\item \textsuperscript{298}Fisch, supra note 222, at 1144.
\end{itemize}
rules on shareholder proposals led to litigation such as the 1947 Third Circuit case of SEC v. Transamerica Corp., the SEC began to specify qualifications and grounds for management exclusion under the Rule until an impressive 13 such grounds have now accumulated. In stenciling out the matters permissible for shareholder proposals against the wide open rights of shareholders at annual meetings under state law, Rule 14a-8 distorted the (state law) balance of power between shareholders and management. This has already been discussed in detail above.

Beyond the over-breadth of the specific exclusions, the manner in which the SEC has interpreted vague terms like "ordinary business operations" has also worked to shareholders' disadvantage. It has been the norm that a matter could be considered "ordinary" until it causes enough damage to gain a prominent place in the media. For example, despite a Congressional intent at the time of the Exchange Act to address excessive executive compensation, the SEC allowed proposals regarding compensation to be excluded as affecting "ordinary business operations" until the issue caused enough controversy to enter into widespread public debate, and then denied their exclusion. Similarly, shareholder initiatives on auditor independences had to follow, rather than anticipate, newsworthy problems. In December 2002, as public interest in the question of expensing stock options reached a high point, the SEC reversed an earlier position that allowed exclusion of proposals regarding this issue. This case is particularly egregious in light of the then SEC Chairman, Arthur Levitt's failed attempt in 1993 to support an accounting standard that would have required the expensing of stock options, which

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299 163 F.2d 511 (3d Cir. 1947).
300 See 17 C.F.R. § 240.14a-8. In addition to eligibility requirements and procedural requirements to qualify for submission, a proposal may be excluded if (1) it is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization; (2) if implemented, it would cause the company to violate any state, federal, or foreign law to which it is subject; (3) it or its supporting statement is contrary to an SEC proxy rules, including Rule 14a-9, prohibiting materially false or misleading statements in proxy soliciting materials; (4) it relates to the redress of a personal claim or grievance against the company or any other person, or seeks a personal benefit; (5) it relates to operations which account for less than 5% of the company's total assets and for less than 5% of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company’s business; (6) the company would lack the power or authority to implement it; (7) it deals with a matter relating to the company's ordinary business operations; (8) it relates to an election for membership on the company's board of directors or analogous governing body; (9) it directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting; (10) the company has already substantially implemented the proposal; (11) it substantially duplicates another proposal previously submitted that will be included in the proxy materials; (12) it deals with substantially the same subject matter as another proposal that has been previously included in the proxy materials in the past 5 years and has received little support; or (13) it relates to specific amounts of cash or stock dividends. 17 C.F.R. § 240.14a-8(i).
301 Fisch, supra note 222, at 1151.
302 See Part IV.B.
303 Fisch, supra note 222, at 1158-59.
304 See Quinn, supra note 188, at 29.
305 Id. at 30.
would seem to indicate that he deemed the matter extra-ordinary. The governance benefit of privately owned organizations with "representative democratic" structures is precisely to allow ideas for desirable change to flow from the grass roots when it cannot be imposed centrally – such as by the SEC – which makes the SEC's "wait and see" policy particularly troubling. It is difficult to deny Prof. Fisch's argument that this policy frustrates the valuable, innovative potential of shareholders, "to anticipate and to initiate public debate, instead of awaiting SEC staff recognition that the issues have developed into a significant policy matter."\textsuperscript{307} Tethering shareholder voice behind broad, public opinion is also a likely cause of some of today's shareholder apathy and has perhaps contributed to the "heard aspect" of similar proposals flooding into management as soon as the media certifies that the matter has indeed entered "widespread public debate."

7. \textit{Eliminating the Carrot of "Soft Information"}

Another positive development for shareholder monitoring came in 2000, when the SEC adopted Regulation FD.\textsuperscript{308} Regulation FD requires that any material non-public information disclosed to specified persons (including investment managers), not acting in a fiduciary capacity or under a confidentiality agreement, also be disclosed simultaneously (if the disclosure was intentional) or promptly (if unintentional) to the public.\textsuperscript{309} Prior to this rule, as Prof. Coffee explained, "[i]nstitutional investors who oppose[d] management risk[ed] cutting themselves off from the flow of soft information that management provides to 'friendly' securities analysts and institutions."\textsuperscript{310} Thus, while the DOL's administration of ERISA and the similar rules that followed suit gave institutions reason to exercise voice, Regulation FD removed a lever that portfolio companies could use to punish them for such exercise.

8. \textit{One Small Step Towards Shareholders Actually Electing Directors}

Part IV of this paper showed how electing directors by "plurality" vote means electing whoever is on the list of nominees, and that although state law permits shareholders to nominate candidates for the board, federal law blocks that right by excluding shareholder nominees from the proxy statement and shareholder proposals. This frustration of the shareholders' right to actually elect directors is a fundamental weakness of the default governance structures found in U.S. corporate statutes. In 2003, the SEC issued rules to increase the independence of board nominating committees and the disclosure of their procedures.\textsuperscript{311} A Schedule 14A must now state whether the committee considers candidates

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\begin{itemize}
\item Fisch, \textit{supra} note 222, at 1162.
\item 17 C.F.R. § 243.100
\item See 17 C.F.R. § 243.100(a) and (b).
\item Coffee, \textit{Liquidity vs. Control}, \textit{supra} note 2, at 1323.
\end{itemize}
\end{flushleft}
recommended by shareholders and name any such candidate recommended by a major shareholder who was rejected. The complex requirements of the provision aim to create a neutral nominating committee within the board to address shareholder concerns about the board's accountability. This use of complex independence and disclosure requirements to create carefully vetted trustees charged with caring for shareholder interests – as opposed to giving shareholders a voice to speak up for their own interests – is what a recent study has called the "trusteeship strategy," which is to be distinguished from the "decision rights strategy", which gives shareholders influence through direct vote. As discussed in detail above, the opponents of shareholder voice distrust structures giving shareholders decision rights, and instead place more confidence in structures that give management paternal powers to protect shareholders from themselves. As seen from the way that this rule glided to adoption without much discussion – in comparison to the bitterly debated shareholder nominations rule, discussed below – we can understand why the SEC may wish to make the use of independent committees as a safe compromise when addressing shareholder rights.

Nevertheless, in 2003 the SEC also proposed a new Rule 14a-11, which would employ a qualified "decision rights strategy" by allowing shareholders to nominate candidates for election to the

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312 Item 7 of Schedule 14A, 17 C.F.R. § 240.14a–101 now contains a "comply or explain" duty under which a registrant company must state in its proxy statement whether it has undertaken a number of acts and if not, explain why. Disclosures include the presence of a nominating committee (describing its composition and whether its charter has been posted on the company's website), whether its members are independent, whether it has a policy for considering shareholder nominees (describing its material elements and the procedure), any specific minimum requirements for a board candidate, the process used to evaluate candidates, the origin of the candidates recently included on the proxy card, any service used to evaluate candidates, any candidate nominated in a timely manner by a 5 %, one-year shareholder or group of shareholders who was not included on the card (provided the shareholder and the rejected candidate consent to disclosure).

313 See KRAAKMAN ET AL., ANATOMY, supra note 42, at 46-51.

314 This is certainly the case with the preferred method of creating independent directors to act in a tutelary fashion for shareholders on the board rather than making directors accountable to shareholders for their appointments. This faith in the trustee strategy is evidenced by recourse to independent directors in § 10A(m)(3)(A) Securities Exchange Act of 1934, as amended by § 301 of the ‘Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 ("Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent."). The U.S. Securities and Exchange Commission has explained the utility of this requirement as follows: "Management may face market pressures for short-term performance and corresponding pressures to satisfy market expectations. . . . An independent audit committee with adequate resources helps to overcome this problem and to align corporate interests with those of shareholders." Final Rule: Standards Relating to Listed Company Audit Committees, SEC Release Nos. 33–8220; 34–47654, 68 Fed. Reg. 18788, 18790-91 (Apr. 16, 2003). For an older formulation of a similar requirement, see THE AMERICAN LAW INSTITUTE, supra note 101, at § 3A.01: "It is recommended as a matter of corporate practice that (a) the board of every large publicly held corporation [§ 1.24] should have a majority of directors who are free of any significant relationship [§ 1.34] with the corporation's senior executives . . . .". Robert Monks describes the attitude of trusting wise (disinterested, independent, prudent) managers to care for shareholders, rather than allowing shareholders to speak for themselves, a yearning for the "benevolent dictatorship" of the "philosopher king". See MONKS, supra note 239, at 112-14.

315 See Security Holder Nominations Proposal, supra note 152.
board. As the SEC explained in its proposing release, it had considered allowing shareholder nominations on proxy materials in 1977, but due to the "emerging concept of nominating committees," decided to wait and monitor the situation; in 2003, the SEC observed that, "it appears that the presence of nominating committees has not eliminated the concerns among some security holders with regard to the barriers to meaningful participation in the proxy process in connection with the nomination and election of directors." However, the proposed rule for shareholder nominations was very limited. It would apply to registered companies only under specified conditions, and allow only certain shareholders to nominate a small minority of the candidates for the board. The advantage would be inclusion of the nominee in the company's proxy materials, as opposed to having to run and pay for a proxy contest. Detailed independence requirements were included to appease the fear that, even if elected by a majority of the shareholders, the nominee if elected would be a special interest director. The proposed rule's triggering and holding requirements, as well as the small number of candidate slots it allows, makes it a less than perfect tool for shareholder voice in today's economy. The odd, indirect triggering by withhold votes is particularly troubling because it both tacks a secondary (federal) significance on a (state law) vote for directors and, as a matter of policy, seems to express distrust in shareholders' ability simply to express their own choice to apply the rule.

316 Security Holder Nominations Proposal, supra note 152, at 60785-86.
317 The mechanism of the proposed rule would be applicable under two conditions. First, shareholders could simply opt in to its application by voting to do so. See Security Holder Nominations Proposal, supra note 152, at 60819. The second trigger would be if "at least one of the registrant’s nominees for the board of directors for whom the registrant solicited proxies received ‘withhold’ votes from more than 35% of the votes cast at an annual meeting of security holders,” except in the case of a contested election. Id.
318 A nominating shareholder or shareholder group would have to have held more than 5% of the registrant's securities that are "eligible to vote for the election of directors" continuously for at least two years and intend to continue to hold those securities through the date of the subject election of directors. See Security Holder Nominations Proposal, supra note 152, at 60820.
319 One nominee would be permitted in a board of up to eight members, two nominees in a board of between nine and 19 members, and three nominees in a board of 20 or more members. See Security Holder Nominations Proposal, supra note 152, at 60822.
320 The independence requirement resembles existing, similar requirements for all independent board members, but is focused on guarding against ties specifically between the nominee and the nominating shareholder or group of shareholders. It prohibits the nominee from being first, the nominating shareholder or a member of the nominating group, second, an employee of the nominating shareholder or any group member, third, a recipient of fees from the nominating shareholder or group member, fourth, an executive officer or director of the nominating shareholder or any group member, fifth, neither controlling nor controlled by the nominating shareholder or any group member, and sixth, in compliance with the applicable independence requirements for directors under the relevant stock exchange rules. See Security Holder Nominations Proposal, supra note 152, at 60820-21.
321 The blind triggering event of a 35% withhold vote (see supra note 317) would ascribe a secondary meaning to votes that shareholders intend to cast in favor of or withhold from the election of a particular director, ascribing a symbolic value to a totally different action, and treating shareholders as a group that cannot think and act for itself. This blind trigger would also interfere with the exercise of a state law right. As Prof. John Coffee has remarked, this secondary meaning would “skew” (distort)
Like the proposed rules that were eventually adopted in 1992, the Security Holder Nominations Proposal was immediately subject to a withering assault by its opponents. In the words of Georgeson Shareholder, "the proposal evoked bitter controversy, inspired an estimated 16,000 comment letters and divided the Commission." According to a report prepared by the organization, Public Citizens Congress Watch, the Business Roundtable led a costly and widespread lobby against the rule that targeted not only the SEC, but also the Congress, the White House, and the Departments of Treasury and of Commerce. The resulting siege on the SEC brought the Wall Street Journal to remark: "At a time when President George W. Bush was putting the U.S. military behind democracy in Iraq, the SEC chairman was backing a baby step toward democracy in the boardroom. . . . Since then, however, [the SEC Chairman,] Mr. Donaldson has been in retreat." On June 1, 2005, SEC Chairman Donaldson announced that he would resign his office effective June 30. Regardless of the outcome of the very limited rule set forth in the Security Holders Nominations Proposal, the proposal and the attention it focused on the problem rule has already had a significant effect. Both ISS and Georgeson Shareholder observed in the reports on the 2004 proxy season that the "informal" negotiations between management and shareholders that take place against the backdrop of the legal rights of each party were more vigorous and – according to ISS – more civil, than in past proxy seasons. Thus even the proposal of the rule marked some progress. As discussed above in Part V.B.6, if the existing block to a shareholder's nomination rights under state law is to be removed, it may perhaps more effectively be accomplished in Rule 14a-8.

Given the steady growth of sophisticated investors on the U.S. market, the increasing access to well-organized information and the overall impact of information technology on collective action, it would seem probable that open exercise of shareholder voice will continue to gain support until an effective system of communication and influence is achieved. One argument against this position is the opinion that most institutional shareholders are not interested in committing significant funds to

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322 GEORGESON SHAREHOLDER, 2004 ANNUAL CORPORATE GOVERNANCE REVIEW i (2004).
326 “To an impressive degree, constructive dialogue between shareholders and corporations replaced confrontation. The action took place off stage, the results out of the limelight. But evidence suggests that the consequences were real—and to the mutual benefit of both corporations and institutional investors.” INSTITUTIONAL SHAREHOLDER SERVICES, supra note 210, at 3, and "Like the proverbial elephant in the drawing room, the access rule was an unacknowledged but powerful factor influencing the mood and behavior of companies and shareholders at 2004 annual meetings." GEORGESON SHAREHOLDER, supra note 322, at i.
corporate governance measures or giving their competitors a free ride on the improvements such measures bring. The availability of cost-spreading proxy organizations and the steadily decreasing costs of information and communication would seem to speak against this argument. Another argument is found in the intensity of the corporate lobby against any improvements in the proxy system. This argument would seem to be bolstered by the trench warfare that explodes whenever an increase in shareholder voice is proposed. However, the corporate lobby is being countered by an increasingly organized institutional shareholder lobby, and it appears that the economic trend toward mediated investment would serve to increase the strength of the latter group. Certainly, if shareholder voice does become a viable option to exit, newly "empowered" shareholders will have to be subjected to fitting duties.

C. Conclusion

This paper has shown that some of the principal arguments against shareholder voice are unfounded. It has shown that shareholders do own corporations, and that the nature of their property interest is structured to meet the needs of the relationships found in stock corporations. The paper has explained that fiduciary and other duties restrain the actions of shareholders just as they do those of management, and that critics cannot reasonably expect court-imposed fiduciary duties to extend beyond the actual powers of shareholders. It has also illustrated how, although corporate statutes give shareholders complete power to structure governance as they will, the default governance structures of U.S. corporations leaves shareholders almost powerless to initiate any sort of action, and the interaction between state and federal law makes it almost impossible for shareholders to elect directors of their choice. Lastly, the paper has recalled how the percentage of U.S. corporate equities owned by institutional investors has increased dramatically in recent decades, and it has outlined some of the major developments in shareholder rights that followed this increase. I hope that this paper deflated some of the strong rhetoric used against shareholder voice by contrasting rhetoric to law, and that it illustrated why the picture of weak owners painted in the early 20th century should be updated to new circumstances, which will help avoid projecting an old description as a current normative model that perpetuates the inevitability of "managerialism", perhaps better known as "dirigisme".
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