COLUMBIA UNIVERSITY
LAW SCHOOL

Jerome L. Greene Hall
435 West 116th Street
New York, NY 10027

814

John C. Coffee, Jr.
Adolf A. Berle Professor of Law

Phone: (212) 854-2833
Fax: (212) 854-9015
e-mail: jcoffee@law.columbia.edu

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Alan Beller
Director, Division of Corporate Finance
Securities and Exchange Commission Headquarters
405 Fifth Street, N.W.
Washington, D.C. 20549

Roundtable on Securityholder Nominations of Directors

Dear Alan:

Thanks for the opportunity to testify at your Roundtable hearings last week, and pardon me if I inflict one more opinion on you, but the attached column is in essence my testimony last week, cleaned up slightly. Put as simply as possible, I believe that proposed Rule 14a-11 lives or dies on a "procedure versus substance" distinction. In this light, your proposed alternative condition (that the issuer have failed to implement a shareholder-passed proposal) sounds dangerously substantive (as well as complicated). Indeed, you might be well advised to consider simplifying your triggering conditions to some simple nominating petition requirement (which again sounds more procedural in character). Feel free to ignore this gratuitous advice, but you did drive me to put my views down on paper.

Yours ~~Truly,~~

John Coffee

John C. Coffee, Jr.
Adolf A. Berle Professor of Law

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CORPORATE SECURITIES

JOHN C. COFFEE JR.

# *Federalism and the SEC's Proxy Proposals*

Proposed Securities and Exchange Commission (SEC) Rule 14a-11, which would allow shareholders of publicly held companies to nominate a limited number of directors under certain special conditions and place these nominations directly on the corporation's own proxy statement, represents the most controversial and important proposal to emanate from the SEC in over a decade.[1]

At best, it could resurrect the faint, will-o'-the-wisp hopes for "shareholder democracy"; at a minimum, it should enhance the leverage of institutional investors in their negotiations with managements. Precisely for this reason, the SEC has been repeatedly told by corporate loyalists, including most bar associations, that its proposal will produce "balkanized" boards, "special interest" directors and pointless controversy and waste. Predictably, the SEC will not be much impressed by such fulsome rhetoric and will adopt proposed Rule 14a-11, possibly with significantly revised triggering conditions.

Only then will come the important stage. The legality of proposal Rule 14a-11 depends upon where courts draw the line between the realm of corporate governance, regulated primarily by state corporate law, and the realm of securities regulation, where the SEC is the primary regulator.

**John C. Coffee Jr.** *is the Adolf A. Berle Professor Law at Columbia University Law School and director of its Center on Corporate Governance. This column is based on his testimony at the SEC's March 10 Roundtable on Shareholder Nominations of Directors.*

Not only has this issue of federalism received less attention, but, as the more astute commentators have long recognized, there is no clear-cut bright line that clearly divides these two contexts.[2] In this regard, Section 14(a) of the Securities Exchange Act of 1934, which gives the SEC authority to adopt rules regulating the proxy solicitation process, is a particularly problematic provision because it does not focus exclusively on disclosure; rather, it contemplates SEC rules regulating procedure in order to grant shareholders a "fair" right of corporate suffrage.

Clearly, however, the SEC does not possess unlimited authority under Section 14(a). Rather, as the SEC painfully learned in *Business Roundtable v. SEC*,[3] which invalidated SEC Rule 19c-4, which had barred "reporting" companies from taking any corporate action that had the effect of "disparately reducing" the per share voting rights of existing common stockholders, the SEC cannot simply overrule long-established substantive rules of state corporate law because they are inconsistent with a "fair right of corporate suffrage."[4]

But the *Business Roundtable* case does not, itself, draw a clear cut or carefully analyzed line. It did not need to. It saw that Rule 19c-4, which would have precluded the issuance of super-voting stock, or similar weighted or capped voting schemes, by publicly held companies overrode state substantive corporate law that permitted corporations to issue stock with disparate voting rights.

After the *Business Roundtable* decision, if a confrontation between state and federal law can be reduced to a conflict between the state's power to regulate substantive corporate law and the SEC's power under a basically disclosure-oriented statute, state law is likely to prevail. This was also the clear message in the Supreme Court's earlier holding in *Santa Fe Industries, Inc. v. Green*.[5]

But that is not the confrontation involved in the debate over proposed Rule 14a-11. Indeed, the SEC has tried to frame Rule 14a-11 as a rule that does not intrude into the sphere of substantive corporate governance regulated by state law because it applies in the SEC's words "only where the company's security holders have an existing, applicable state law right to nominate a candidate or candidates for election as director."[6]

As discussed below, this framing of the issue is slightly disingenuous. Although state law never prohibits a shareholder from making a director nomination at the annual meeting, state law does permit bylaws and charter provisions that may qualify or condition this right in such a way as to make it impractical to impossible to exercise.

In this light, the true issue presented by proposed Rule 14a-11 involves the degree to which Section 14(a) permits the SEC to mandate procedures that may conflict with substantive powers that highly flexible and permissive state laws authorize managements to exercise. This issue is far from new, but Rule 14a-11 exacerbates the degree of conflict. Since 1947, Rule 14a-8 has authorized shareholders to place issues on the corporation's agenda for a vote at the annual shareholders' meeting.

This is certainly not a disclosure rule; rather, it is a rule aimed at mandating procedures to ensure "fair corporate suffrage." Yet courts have largely recognized a private cause of action under Rule 14a-8 by which shareholders may enforce their rights to make and vote on such proposals.[7]

To be sure, in the case of Rule 14a-8, the conflict between state and federal law is mitigated by the facts that (i) the shareholder proposals that it authorizes are in most instances precatory, rather than mandatory, and (ii) the proposal must be considered a "proper subject" for a shareholder vote under state law.[8] In reality, Rule 14a-11 is largely an appendage — or, more accurately, a footnote —to Rule 14a-8, because in a limited range of cases it simply overrules the exclusion in Rule 14a-8 that denies shareholders the ability to use Rule 14a-8's procedures to nominate directors. Rule 14a-11 presents a sharper conflict between state and federal law, however, because its nominations will be real, rather than precatory.

This continuity between Rule 14a-8 and proposed Rule 14a-11 implies that judicial analysis and evaluation of the latter rule should begin from the point already reached by courts in evaluating the former rule. Here, the most notable fact about Rule 14a-8 is that it is not a disclosure rule, but a procedural rule.

Courts have upheld it on two distinct rationales. First, as the D.C. Circuit said in 1970 in *Medical Committee for Human Rights v. SEC*, "[t]hrough Section 14 of the Act, Congress has invested the Securities and Exchange Commission with sweeping authority to regulate the solicitation of corporate proxies."[9] This rationale that Section 14 was intended "to give true vitality to the concept of corporate democracy"[10] did not carry the day in *Business Roundtable*, but in that case the SEC was seeking to do much more than specify mandatory procedures to apply to an acknowledged right under state law; rather, it was seeking to invalidate the substantive power that existed under state law to create supervoting stock.

That the right of "fair corporate suffrage" does not extend this far does not mean that it cannot be used as the justification for more limited procedural rights.

Second, the original justification advanced by the SEC for Rule 14a-8 was a disclosure-oriented one that applies equally to the case of Rule 14a-11.

If a management knows that a shareholder proposal will be made at an annual meeting, it is arguably misleading for management to seek shareholder proxy voting authority, without disclosing the proposal and a fair summary of the proponent's justifications for the proposal.[11] By analogy, one can similarly argue that if management knows that shareholders will nominate one or more candidates for the board at the annual meeting, management should not seek proxy authority for its own candidates without disclosing these other candidates and some background data on them.

Once it is recognized that the shareholder already has the right under Rule 14a-4 to withhold consent for some or all of management's nominees on management's proxy, federal law already regulates the process of voting, and it is but a short step to extend this procedural right to permit the shareholders to vote on that same proxy card for the insurgent candidates.

So viewed, Rule 14a-8 does not invade the province of state law, but simply implements voting rights that exist under state law and reconciles them with the SEC's own invention, the proxy statement. As Milton Freeman, the draftsman of Rule 10b-5 and frequently a critic of the SEC, wrote as long ago as 1957: "[Rule 14a-8] is an almost necessary consequence of the status of the individual shareholder under the laws of various states of incorporation. . . . [It] is merely a recognition of rights granted by state law."[12]

Indeed, since at least 1940, a long list of respected commentators have argued that the proxy rules' underlying procedural goal was to give the absent shareholder the same rights as were possessed by those shareholders who could personally attend the meeting.[13] On this basis, Rule 14a-11 is fully consistent with this general understanding of the proxy rules, because it equalizes the position of an absent shareholder with that of a shareholder who was physically present at the meeting and who could nominate directors.

Even the *Business Roundtable* court acknowledged — albeit in a grudging and cramped way — that the proxy rules had procedural goals beyond disclosure. Specifically, it cited Rule 14a-4(b)(2), which permits the shareholder to withhold consent from individual nominees.[14] The recent Disney annual meeting in which 43 percent of the shareholders withheld consent from Michael Eisner shows the force of this provision.

If this obvious distinction between substance and procedure is not accepted, then not only does proposed Rule 14a-11 fail, but so also Rules 14a-4, 14a-7, 14a-8 seem equally vulnerable. If the business lobbies opposing Rule 14a-11 were to eviscerate the SEC's proxy rules to this extent, new Congressional legislation would become likely — with unpredictable results.

Given the obvious force of this substance/procedure distinction, are there any remaining problems relating to the legality of proposed Rule 14a-11? In truth, there is an important and only implicitly recognized ambiguity in the language of the proposed Rule.

To understand this, let's begin with a well-known Delaware decision, *Stroud v. Grace*,[15] which upheld charter and bylaw provisions that required nominees for directors to be screened by a committee of the board and to pass certain eligibility criteria that required them to have "substantial experience in line (as distinct from staff) positions in the management of substantial private institutions."

Although Delaware law does not mandate any such eligibility conditions, it does permit Delaware corporations to impose them. Proposed Rule 14a-11(a)(1) provides, somewhat ambiguously in this regard, that its right to nominate directors applies only where "[a]pplicable state law does not prohibit the registrant's security holders from nominating a candidate or candidates for election as a director."

Does "applicable state law" here include charter or bylaw provisions, authorized by Delaware law, that block shareholder nominations from being considered by shareholders? Whatever the SEC's uncertain intent in this regard, it seems likely that the *Business Roundtable* court, or any similarly minded panel, would find a charter provision similar to that in *Stroud v. Grace* to be a substantive provision of state law, much like supervoting stock, that Section 14(a) does not authorize the SEC to override.

This does not mean that the SEC lacks any counterargument. In *SEC v. Transamerica Corp.*,[16] the commission convinced the Third Circuit that state law could not be allowed to frustrate federal regulation. There, John Gilbert, the best known shareholder activist of his day (or "gadfly" in the parlance of his time), submitted a proposal that the Transamerica's bylaws be amended both to provide for the annual election of independent auditors by the shareholders and to repeal a bylaw requiring that notice of any bylaw amendment be contained in the notice of the annual meeting.

Predictably, Transamerica refused to include his proposals in its proxy statement because they had not been mentioned in the notice of the meeting. The District Court agreed with Transamerica's argument, but the Third Circuit reversed, accepting the SEC's position that Transamerica's advance notice bylaw could not be used "as a block or strainer to prevent any proposal to amend the bylaws, which it may deem unsuitable, from reaching a vote at an annual meeting of stockholders."[17]

Such an insurmountable obstacle, it said, would impermissibly "serve to circumvent the intent of Congress in enacting the Securities Exchange Act of 1934...[, which was] to require fair opportunity for the operation of corporate suffrage."[18]

Today, it is debatable, and probably less likely, that courts would read the intent of Congress in enacting Section 14(a) as broadly as did the *Transamerica* court.

Historically, the stronger claim is to ascribe to Congress an intent to place the absent shareholder in the same position as the shareholder who was present at the meeting. If so, both shareholders would be subject to the *Transamerica* bylaw or the *Stroud v. Grace* charter provision.

Should this be a cause for alarm? Not really. Under recent Delaware decisions, most notably *MM Companies v. Liquid Audio*,[19] it is highly unlikely that a sweepingly preemptive bylaw, such as that employed in *Transamerica*, would pass muster with the Delaware courts, which today require attempts to impede or frustrate the shareholder's franchise to satisfy a forbidding "compelling justification" test. Nor are corporations likely to rush to adopt such preemptive bylaws, as they would likely lower their corporate governance rankings with the newly emerging governance rating services.

Hence, the proper balance between federal and state law should be to uphold Rule 14a-4, but subject bylaw or charter obstacles to its exercise to a state law test as to their reasonableness.[20] This compromise respects federalism, but also recognizes that Section 14(a) is more than a simple disclosure statute.

(1) Rule 14a-11 was proposed in Securities Exch. Act Release No. 34-48626 (Oct. 26, 2003) 68 FR 60784. Under the proposed rule, shareholders holding 5 percent or more of a non-foreign, "reporting" company's stock could place nominations for between one and three directors, depending on the size of their corporation's board, if one of two triggering events occurred: (1) 35 percent or more of the corporation's shareholders voted to withhold consent from at least one of the company's nominees for its board of directors at an annual meeting of security holders held after Jan. 1, 2004, or (2) a security holder proposal submitted pursuant to SEC Rule 14a-8 providing that the company become subject to Rule 14a-11's "direct access" security holder nomination procedure was adopted by a vote of more than 50 percent of the votes cast on the proposal at an annual meeting occurring after Jan. 1, 2004. A third, alternative condition also proposed by the SEC in this same release was that shareholders adopted a proposal pursuant to Rule 14a-8 that the company refused or declined to implement. The status of this last triggering condition remains uncertain.

(2) See, e.g. Stephen Bainbridge, Redirecting State Takeover Laws at Proxy Contests, 1992 Wis. L. Rev. 1071, 1107-1111 (1992); Roberta Karmel, Qualitative Standards for Qualified Securities: SEC Regulation of Voting Rights, 36 Catholic U. L. Rev. 809, 814 (1987); Alan Palmiter, The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation, 45 Ala. L. Rev. 879 (1994).

(3) 905 F. 2d 406 (D.C. Cir. 1990).

(4) Id. at 410-414.

(5) 430 U.S. 462 (1979) (Rule 10b-5 could not be applied to bar a fully disclosed fiduciary breach).

(6) See Release No. 34-48626, 68 FR 60784, at 60787. Proposed Rule 14a-11(a)(1) sets forth this provision, which permits security holder nominations unless applicable state law prohibits the company's security holders from nominating a candidate or candidates as directors. No state appears to have enacted such a prohibition.

(7) See, e.g. *Roosevelt v. E.J. DuPont de Neumours & Co.*, 958 F. 2d 416, 418-25 (D.C. Cir. 1992); cf. *Rauchman v. Mobil Corp.*, 739 F. 2d 205 (6th Cir. 1984) (assuming private right of action exists under Rule 14a-8); *Amalgamated Clothing and Textile Workers Union v. Wal-Mart Stores, Inc.*, 821 F. Supp. 877, 879 n. 1 (S.D.N.Y. 1993).

(8) See Rule 14a-8(i) Question 9 (proposal may be excluded if it "is not a proper subject for action by shareholders under laws of jurisdiction of company's organization").

(9) 432 F. 2d 659, 671 (D.C. Cir. 1970), vacated as moot, 404 U.S. 403 (1972).

(10) Id. at 676.

(11) See Hearings on SEC Proxy Rules Before the House Comm. On Interstate and Foreign Commerce, 78th Cong., 1st Sess. 169-170 (1943), cited in Staff of Div. of Corporate Finance, Securities and Exchange Commission, 96th Cong., 2d Sess., REPORT ON CORPORATE ACCOUNTABILITY 144 (1980).

(12) See Milton V. Freeman, An Estimate of the Practical Consequences of the Stockholder's Proposal Rule, 34 U. Det. L.J. 549, 549 (1957)

(13) See Sheldon Bernstein & Henry G. Fischer, The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy, 7 U. Chi. L. Rev. 226 (1940); David C. Bayne, The Basic Rationale of Proper Subject, 34 U. Det. L. J. 575, 591 (1957); see also Louis Loss and Joel Seligman, SECURITIES REGULATION, Vol. IV at 1937-1938 (3rd ed. 1990) (proxy rules seek "to make the proxy device the closest practical substitute for attendance at the meeting.").

(14) 905 F. 2d at 411.

(15) 606 A. 2d 75 (Del. 1992).

(16) 163 F. 2d 511 (3d Cir. 1947), cert. denied, 332 U.S. 847 (1948).

(17) Id. at 516.

(18) Id. at 518.

(19) 813 A. 2d 1118 (Del. 2003).

(20) The SEC does have authority, however, to specify uniform procedures applicable to all "reporting" companies. In addition, a strong case can be made that bylaws cannot discriminate against the absent shareholder. Thus, while all shareholders could be made subject to a bylaw that required that not less than ten percent of all the shares joined in any nomination of a director, such a percentage require requirement could not be made exclusively applicable to absent shareholders seeking to use the SEC's new procedure.