Shareholder Power and Corporate Governance

Seminar: Issues in Corporate Governance

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I. Introduction

Minority shareholders should be given more power in corporate governance to hold directors and officers accountable by allowing these shareholders to make proposals to be included in proxy statements, to change corporate bylaws, and to limit the ability of directors to include exculpatory provisions in the corporate charter. Informed shareholders who can make fundamental corporate changes are in a better position to hold the board of directors accountable for acts detrimental to the corporation and breaches of duties directors owe their fiduciaries. This paper suggests that the proposed changes in corporate governance will allow shareholders to hold the board accountable and prevent the board from insulating itself from liability through the use of exculpatory provisions.

This paper asserts that there are five powers that shareholders should have in corporations to allow them to hold directors and officers accountable.

First, shareholders should be able to make proposals on proxy statements without the burden of SEC Rule 14a-8. SEC Rule 14a-8 deals with the process shareholders must go through to have their proposals included on a company's proxy card.[1] Under it, a shareholder must file a proxy statement for any solicitation. "Solicitation" is interpreted broadly by the SEC to include any type of shareholder communication. The proxy requirement makes communication too expensive for shareholders.

Second, shareholders should be able to propose changes to the corporate charter and corporate bylaws without fear of rejection by the board of directors. Today, shareholders submit a non-binding resolution or a precatory proposal to the board. The board making the final decision may reject the resolution, even if a majority of the shareholders supports it. Powers one and two combined would allow shareholders to submit to the board of directors proposals to change the charter or bylaws. Proposals would be included in proxy statements and adopted by a majority shareholder vote.

Third, shareholders should be able to limit the ability of directors to include exculpatory provisions in the corporate charter. Exculpatory provisions allow a corporation to limit or eliminate directors' personal liability for breaching

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[1] Shareholder Proposals, 17 C.F.R. § 240.14a-8 (2005).

the duty of care.[2] This, in turn, eliminates director accountability to the shareholders and other corporate stakeholders.

Fourth, minority shareholders should be able to get help from institutional investors who have the resources to initiate change in a corporation. Typically, institutional investors hold large chunks of stock making them influential in corporate decision making.[3] These large investors own the securities for their beneficiaries to whom they owe fiduciary duties.[4] As discussed later, institutional investors should assist minority shareholders by providing guidance in submitting proposals, voting for changes, and acting as the lead plaintiff in shareholder derivative suits.

Fifth, this paper proposes that the shareholders should approve both directors and officers before their nomination or employment, or alternatively, shareholders should nominate directors. Directors are initially elected by the shareholders when a corporation is formed[5], but after that point, new directors are nominated by the incumbent board or a nominating committee formed by the

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[2] Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 Hous. L. Rev. 393, 412.
[3] Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 Tex. L. Rev. 1615, 1651 (2005) (reviewing *Lucian Bebchuk and Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation.* (2004)).
[4] Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 Bus. Law. 1, 2 (2004).
[5] D. Gordon Smith, *The Shareholder Primacy Norm*, 23 Iowa J. Corp. L. 277, 299.

incumbent board.[6] This leads to incumbent directors being nominated again: widely dispersed shareholders are often powerless to stop it. The SEC proposed Rule 14a-11 that would allow shareholders to place board nominees on the ballot.[7] Upon the occurrence of certain specified events and subject to some restrictions, shareholder nominees will be placed on the company's proxy statement and ballot, thus granting more power to the shareholders.[8]

Also, this paper proposes certain requirements that shareholders must meet to take advantage of the increased power. Minority shareholders must have at least five hundred dollars invested for a period of at least one year. Through institutional investors, minority shareholders can form coalitions to submit proposals. The corporation can also set its own restrictions in the corporate charter however, this will be subject to approval by a majority of shareholders.

The proposals mentioned, and issues regarding shareholder power and corporate law, centers around three different academic and legal theories. These theories are; shareholder primacy, director primacy, and team production.

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[6] See Karmel, supra note 4 at 10-14.

[7] Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 14, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274).

[8] See Bainbridge, supra note 3, at 1644.

Shareholder primacy is the dominant theory of the firm[9] and is considered fundamental to corporate law.[10] This theory will be contrasted with the two competing theories; director primacy and the team production theory. Director primacy suggests that shareholders exercise no control over day to day corporate operations or long term policymaking.[11] These decisions are assigned to the board of directors or their subordinates.[12] Finally, the team production theory, which operates under the mediating hierarchy approach to corporate governance,[13] is a "solid theoretical foundation for the basic structure of public corporation law."[14] Under this approach, the board acts as problem solver for all the corporations constituents and makes decisions to benefit stakeholders as well as stockholders.[15] These three theories are discussed in detail later in part III.

Corporate governance does not follow the seemingly dominate shareholder primacy theory. This paper suggests that, while there may not be a controlling theory of corporate governance, corporate law is best served by giving shareholders greater power to hold directors liable. Even after Enron,

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[9] *Id.* at 15.
[10]See Smith, supra note 5, at 280.
[11] Steven M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547, 574 (2003).
[12] *Id.*
[13] Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247, 276 (1999).
[14] *Id*.
[15] Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. Corp. L. 743, 746.

directors are protected from liability for failing to perform their duties as directors.[16] Part II sets forth the background of corporate governance as it relates to shareholders, proposals, exculpatory provisions, and institutional investors. Part III discusses the primary managerial power models that influence the balance of corporate power, including application in practice and theory. Part IV discusses arguments for increasing shareholder control in the corporation and making it easier for shareholders to hold directors and officers accountable. Finally, Part V discusses the arguments against giving shareholders more corporate control to make fundamental changes.

II. BACKGROUND

A. Shareholders

It is first necessary to discuss where shareholders stand in the corporate environment. This discussion includes the current state of the law and difficulties shareholders face when making proposals on proxy statements, changing the corporate charter, preventing a change or initiating a change to corporate bylaws, and limiting the use of exculpatory provisions. Also briefly discussed is the role institutional investors play in corporate management.

[16] See Fairfax, supra note 2, at 394.

"U.S. corporate law has long precluded shareholders from initiating any changes in the company's basic governance arrangements."[17] Shareholders existing power is insufficient to adopt governance arrangements that the board of directors and officers disfavor.[18] Most private corporations are run by the shareholders.[19] In publicly traded companies, however, the shareholders simply "vote with their feet" and sell if they are dissatisfied.[20] Moreover, majority shareholders won't take action because they fear liability in three areas; insider trading, shareholder communication, and control person liability.[21]

However, these three areas only apply to majority shareholders. Majority shareholders face potential liability for trading on non-public information. They do not want to get involved in corporate affairs for fear of acquiring material non-public information that will prevent them from trading when it is desirable to do so.[22] Majority shareholders also refuse to take action because of the potential liability stemming from a failure to follow SEC proxy rules.[23] Finally, majority shareholders may be subject to control person liability if they get to

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[17] Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833, 835.
[18] *Id*.
[19] Eric M. Fogel, *Public Company Shareholders Acting as Owners: Three Reforms-Introducing the Oversight Shareholder*, 29 Del. J. Corp. L. 517, 518 (article offers suggestions for ways to allow certain classes of public company shareholders to act like owners).
[20] *Id*.
[21] *Id*.
[22] *Id*. at 521.
[23] *Id*. at 527.

involved in corporate affairs.[24] A shareholder who becomes a control person may owe fiduciary duties to other shareholders and be liable for securities laws violations.[25]

Minority shareholders are typically not in a position to be exposed to this liability because they owe no fiduciary duties to other shareholders or the corporation. They do not risk insider trading liability, shareholder communication liability, or control person liability because they are not close enough to the corporation. This results in minority shareholders becoming aware of management issues only after a publicly announced material adverse event.[26] The proposals presented in this paper will allow shareholders to prevent adverse events from happening by holding the board more accountable for the actions it takes.

B. Proposals

Shareholder proposals are governed by Section 14 and Rule 14a-8 of the Securities and Exchange Act of 1934. The SEC's interpretation of Section 14 is broad enough to encompass any type of shareholder communication.[27] Any person making a solicitation is required to file a proxy statement with the SEC

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[24] *Id.* at 536.
[25] *Id.*
[26] *Id.* at 518.
[27] *Id.* at 530.

that is prepared according to Rule 14a-101, unless the communication is exempt from the proxy requirements.[28] This filing typically requires the help of a lawyer to make sure the shareholder is in compliance with the proxy rules.[29] Under the current rules, no minority shareholder can submit proposals because the price is to high.

Shareholders can also submit a proposal to the board requesting that the proposal be included in the corporation's proxy statement at the corporation's expense. In order to submit a proposal, Rule 14a-8 requires shareholders to continuously hold $2,000 in market value or 1% of a firms securities for one year before the proposal is submitted.[30] Once this requirement is met, and provided the other requirements are met, a proposal may be submitted to the board at a shareholders meeting. Even when the resources are available to submit a proposal, the board may exclude it from the corporate proxy statement by submitting their reasons to the SEC and the shareholder.[31]

Eric Fogel asks in his article, "Why should the owners of a company be saddled with such a burden simply to communicate with fellow owners about

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[28] *Id.* at 529, 530.
[29] *Id.*
[30] Securities and Exchange Act of 1934, 17 C.F.R. § 240.14a-8 (1998).
[31] *Id.*

their company; particularly in this day and age of the internet?"[32] It is understandable that the SEC wants to prevent smaller shareholders or large activist shareholders from causing "chat room" havoc by submitting meaningless proposals.[33] However, the current shareholder proposal rules also prevent meaningful communication between the supposed owners of the firm.

Securities laws today allow shareholders to express their ideas for a charter amendment or bylaw provision through precatory proposals.[34] Minority shareholders may also initiate shareholder resolutions including, for example, resolutions that call for management to initiate a charter amendment or ask management to adopt a certain policy.[35] The problem with these resolutions is that they are non binding.[36] The directors have the final say in whether to adopt these resolutions or not.[37] Whatever decision they make is protected by the nearly unbreakable business judgment rule.[38]

Shareholders also have a veto power which allows them to veto charter amendments and reincorporations proposed by management.[39] However, this power only allows shareholders to veto decisions that would leave them worse

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[32] See Fogel, supra note 19, at 528.
[33] *Id.* at note 15.
[34] See Bebchuk, supra note 17, at 846.
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.* at 862.

off.[40] This means that when management disfavors a value increasing change, the veto power will not allow shareholders to make this change.[41] Under this system, shareholder power to make decisions is essentially non-existent. If shareholders have the power to make charter and bylaw amendments plus veto board decisions, the board of directors are more likely to make changes that benefit shareholders and stakeholders and less likely to make changes that benefit the officers and directors.

C. Exculpatory Provisions

Almost all states permit the use of exculpatory provisions in a corporation's articles of incorporation that relieve the director of liability for breach of fiduciary duty to the corporation or its shareholders.[42] Delaware Code Section 102(b)(7) allows a corporation to include a director exculpatory provision into its articles of incorporation which will protect directors from financial liability for their breach of duty of care.[43] These provisions apply only to due care allegations, and not to allegations of breaches of good faith.[44] But they virtually

[40] *Id*. Bebchuck states that a shareholders veto power is a "negative" power that precludes any worsening of the shareholder's situation. However, this power does not ensure that rule changes increasing shareholder value will take place.
[41] *Id*.
[42] A.J. Boyle, Corporate Litigation in the US and UK: Minority Shareholders Remedies 77-78 (Cambridge University Press 2002) (2002).
[43] Unreported case: *Rothenburg v. Santa Fe Pacific Corp.*, No. 11,749 Court of Chancery of the State of Delaware, New Castle May 18, 1992, 18 Del J. Corp. L. 743.
[44] *Id*.

eliminate any chance that a shareholder or group of shareholders will be able to hold directors accountable. Although shareholders have the final say in whether to include an exculpatory provision,[45] it cannot be removed without director action.[46] By limiting the use of exculpatory provisions, shareholders will have an easier time holding directors accountable for actions that may harm shareholders and the corporation.

D. Institutional Investors:

Institutional investors invest the capital of others to whom they owe fiduciary duties.[47] While some institutions hold shares for the long term,[48] most are short term traders who do not behave like owners of corporate property.[49] However Professor Karmel argues in her article that institutional shareholders have demanded more rights in the wake of recent corporate scandals.[50] Activism by institutional investors can give "real teeth" to shareholder control.[51] Small individual shareholders are typically precluded from playing an active role in corporate governance.[52] However, institutional investors, such as pensions and

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[45] Thomas Rivers, *How to be Good: The Emphasis on Corporate Directors Good Faith in the Post Enron Era.*, 58 Vand. L. Rev. 631.
[46] *Id.*
[47] See Karmel, supra note 4, at 2.
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] See Bainbridge, supra note 3, at 1651.
[52] *Id.*

mutual funds, behave differently than most shareholders.[53] They own large blocks of shares, and are more capable of playing an active role in corporate governance than groups of widely dispersed shareholders.[54] The sheer number of shares these investors own give them more power to hold directors accountable for actions that do not promote shareholder welfare.[55] Institutional investors are more capable than small investors to monitor a corporations performance and initiate changes when board performance lags.[56]

Research in Bainbridge's article suggests that institutional investor activism does not matter.[57] Even the most active institutional investors spend little time on corporate governance matters.[58] Statistics from his article show that a single institution rarely holds large blocks of a corporation's shares[59] However, since most public corporations have millions of outstanding shares, it is understandable that institutions will not have majority ownership. What is important is the fact that institutions own enough shares to have a voice in corporate governance. Institutional investors would make capable shareholder representatives.

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[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] *Id.* (50% of equity securities are owned by institutions. US corporations do not have institutional investors who own more than 5% - 10% of their stock) .

III. MANAGERIAL POWER MODELS:

An explanation of the different theories of corporate governance is necessary to understand the proposals put forth in this paper. There are two broad, all encompassing approaches to corporate law today; the principal-agent approach, and the mediating hierarchy approach.[60] Within the principal-agent approach is the shareholder primacy model and the director primacy model.[61] Scholars and courts follow the principal-agent approach based primarily on the shareholder primacy perspective. The principal-agent approach is contractarian, which means that directors and managers are contractual agents of shareholders with fiduciary obligations to maximize shareholder wealth.[62] Shareholders contract with the corporation for ownership rights like the right to vote and the protection of fiduciary obligations by directors and officers.[63]

Shareholder primacy says that directors of public corporations are accountable only to the shareholders for maximizing the value of their shares.[64] This follows the basic premise for the principal agent model, that shareholders

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[60] Margaret Blair and Lynn Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 Wash. U. L.Q. 403. See also Blair and Stout, supra note 5. These two approaches are the two main approaches which contain the different management theories discussed.
[61] Harry Huchison, *Director Primacy and Corporate Governance: Shareholder Voting Rights Captured by the Accountability/Authority Paradigm*, 36 Loy. U. Chi. L. J. 1111, 1129-1131. See also Blair and Stout, supra note 5, 258-259.
[62] Steven M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547 (2003).
[63] *Id*.
[64] See Blair and Stout, supra note 60 at 404.

are principals while directors and other corporate stakeholders are agents who act to benefit the shareholders.[65] According to Blair and Stout, this gives rise to two themes in corporate governance literature: first, that the main economic problem corporation law addresses is reducing "agency costs" by keeping corporate directors and managers faithful to shareholders' interests; and second, that the primary goal of the public corporation is maximizing shareholders' wealth.[66] Control of the corporation rests with the board of directors who act for the shareholders.[67]

Another model following the principal agent approach is the director primacy model which holds that the board of directors is not an agent of the shareholders, they are the "embodiment of the corporate principal, serving as the nexus of the various contracts making up the corporation."[68] Centralized decision making is required in corporate governance, thus authority is vested, not in the shareholders or managers, but in the board of directors.[69] Huchinson argues that this vesting of control raises legitimate accountability concerns.[70] The business judgment rule exists to solve these concerns by protecting directors

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[65] See Blair and Stout, supra note 13 at 248.
[66] *Id.*
[67] Lynn Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. Pa. L. Rev. 667, 668 (2003).
[68] See Huchinson, supra note 61, at 1136.
[69] *Id.*
[70] *Id.* at 1137.

from being held accountable for business decisions.[71] Under the director primacy model, shareholder wealth maximization is the proper decision making norm, but shareholders are not entitled to either direct or indirect decision making control.[72]

Team production is the idea behind the mediating hierarchy approach.[73] The foundation for the team production approach to corporate governance is that the corporate board serves as mediators between corporate stakeholders and stockholders. This differs from the principal agent approach that assumes the corporation is the shareholders property and corporate directors and officers owe a primary duty to generate wealth for shareholders.[74] Blair and Stout argue that in large corporations with widely dispersed share ownership, it is difficult for shareholders to monitor managers to ensure that they run the corporation to serve shareholder interest.[75] The result is a separation of ownership from control and the problem of monitoring managers and motivating them to act as faithful agents.[76] The team production approach attempts to solve this "agency cost"[77]

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[71] *Id.* Huchinson argues that the business judgment rule is better understood as "a doctrine of abstention pursuant to which the courts refrain from reviewing board decisions unless exacting preconditions for review are satisfied." The business judgment rule is briefly discussed later in this paper.
[72] See Bainbridge, supra note 62 at 550.
[73] See Blair and Stout, supra note 13 at 271.
[74] See Blair and Stout, supra note 15 at 743.
[75] *Id.*
[76] *Id.*

problem by suggesting that the public corporation is a nexus of team specific assets invested by shareholders, managers, employees, and others who want to profit from the corporation.[78] Property rights in the corporation are not owned by the shareholders as the principal agent model assumes but by the corporation itself.[79] Control over these property rights does not rest with the shareholders, but with the board of directors who act as trustees for the whole firm.[80] The board is nominally elected by the shareholders and influenced by corporate officers but as a matter of law, it is insulated from direct command and control of these, or any other, corporate constituents.[81] As Blair and Stout argue, by putting control in the hands of the board of directors, corporate law prevents constituents from using their contracted control to seek rents from the corporation.[82] If these constituents want a larger share of the gains from production they must either appeal to the board of directors or abandon their investment.[83] In the case of shareholders, this means selling their shares.

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[77] *Id*. The agency costs are the costs incurred from monitoring managers to make sure they are acting faithfully towards the shareholders.
[78] *Id* at 746.
[79] *Id*.
[80] *Id*.
[81] *Id. at 746.*
[82] *Id*. Rent seeking occurs when team members of the firm divide gains ex post. Team members have a tendency to argue over which member is entitled to a bigger share. On the other end of the spectrum, when team members try to agree ex ante to a sharing rule, they have incentive to shirk because the cost of shirking will be spread out among every team member.
[83] *Id*.

This leads to the mediating hierarchy approach to corporate law and the mediating role of the corporate board. Since team members cannot easily decide how to divide up the gains by contracting with each other, they agree to give up control over this decision to a mediating hierarch, the board of directors.[84] Under this model the board is not required to maximize shareholder wealth at the expense of stakeholders.[85]

Shareholder primacy and the idea that corporations operate in the interest of shareholders is said to be the legal norm in corporate governance.[86] However, corporate law and corporate governance seem to be following the team production/mediating hierarchy approach.[87] Directors can choose to further their own interests at the expense of shareholder wealth and the shareholders cannot do anything about it since directors are so heavily insulated. When shareholders contract with the corporation by purchasing stock, they hand corporate control to the board. Upon doing this, they lose all bargaining power. The directors do not act to benefit the shareholders like the shareholder primacy model suggests. Instead, "the law grants directors discretion to consider the interests of other

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[84] *Id.*
[85] *Id.*
[86] See Smith, supra, note 5 at 277. (States that the structure of corporate law ensures that corporations generally operate in the interests of shareholders).
[87] See Blair and Stout, supra, note 15 at 746.

corporate constituencies, in addition to the interests of shareholders, in shaping business strategy."[88]

Stakeholders contract with the corporation and know what share of the surplus they will receive. Their bargaining power is not given up when they give up control to the board. The surplus that corporate stakeholders receive is determined ex ante. For example, employees know that they will be paid a certain compensation, corporate creditors contract to be repaid by the corporation and contract for recourse if they are not paid. Shareholders on the other hand, lose their bargaining power when they invest with the firm and give up control to the board of directors. The statutory rights shareholders are vested with[89] are so difficult to employ that they might as well not exist. This paper suggests that shareholders should be given more control in order to get the same bargaining power as other constituents.

The problem with the team production approach and the mediating hierarchy model is: Who holds the board of directors responsible and accountable for breaches of duty? Current corporate law suggests that shareholders are responsible for making sure the directors adequately divide the surplus. If directors do not adequately divide the surplus, shareholders can

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[88] *Id.*
[89] Such as voting rights, the right to sue on behalf of the corporation, etc.

bring derivative actions, make proposals, vote for directors, and veto certain board decisions. What follows is the argument that shareholders should be given greater power in corporate governance to bring derivative actions, make proposals, vote for directors, and veto certain board decisions.

IV. ARGUMENT THAT SHAREHOLDERS SHOULD HAVE MORE CORPORATE CONTROL

Shareholder power is limited to what corporate statutes specify and the company's charter and bylaws.[90] First, Rule 14a-8 of the Securities and Exchange Act of 1934 which governs shareholder proposals[91], and § 14 of the Securities and Exchange Act which governs a company's proxy statements will be discussed as a method of increasing shareholder power. Finally, this section will discuss proposed ways minority shareholders can hold the directors accountable. Other than the proposal to reform proxy rules to favor shareholders, which calls for a change in federal law, the arguments for increasing shareholder power will focus on state law, particularly Delaware law.

The first proposal is that shareholder proposal rules should be reformed making it easier for shareholders to communicate with one another and with the board of directors. One of the biggest barriers to a shareholder's ability to act

[90] See Bebchuk, supra note 17 at 843.
[91] See supra note 30.

comes from the restrictions on shareholder communication.[92] A shareholder who desires to wage a proxy fight to remove incumbent directors must first file a formal proxy statement with the SEC. If the proxy requirements are not met, the shareholder risks stiff liability.[93] The proxy rules prevent frivolous proposals, however the rules also prevent valid concerns and ideas from getting to the board of directors.[94]

This paper proposes a safe harbor rule that a group of minority shareholders or an institutional investor acting on behalf of shareholders be allowed to communicate with other shareholders on any issue.[95] Once the shareholders have communicated, they can act through a designated representative or an institutional investor to submit their proposal to the board. The board can then post the proposal to allow other shareholders to comment. If the proposal has support for two or more consecutive meetings[96] by a majority of the shareholders the board will include it in their proxy statement. Shareholder proposals receiving a majority vote must then be implemented by the board of directors.

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[92] See Fogel, supra note 19 at 527.
[93] *Id*.
[94] *Id*. at 530-533.
[95] *Id* at 534. Fogel proposes a similar to rule to an oversight shareholder which he defines as a class of public company shareholder who hold one percent or higher of a company's shares for six months or more.
[96] See Bebchuk, supra note 17 at 835.

It is necessary to limit the shareholders who can do this however, because there are always those minority shareholders who will make frivolous proposals and communications. To fall under the safe harbor, a shareholder would have to own the shares for at least one year and maintain a minimum investment of $1000. Shareholders falling under the safe harbor are the ones who have invested in the company long term and are concerned about the company's success. Additionally, statements in submitted proposals and communications are subject to Rule 10b-5 of the Securities and Exchange Act of 1934. A full discussion of 10b-5 is beyond the scope of this paper, however it applies to any person in connection with the purchase or sale of any security.[97] Every shareholder may be liable for misstatements or omissions to the SEC and any private party who bought or sold securities.

Another recommendation is to implement the SEC's proposal for shareholder nominations.[98] The proposed rule creates a process where the name of a director nominee of long term security holders, or groups of long term holders, could be included in company proxy materials.[99] The SEC proposal also

[97] 17 C.F.R § 240.10b-5.
[98] Security Holder Director Nominations, 68 Fed. Reg. 60, 784, 60, 786 (Proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274).
[99] See Karmel, supra note 4, at 11 (citing 68 Fed. Reg. at 60, 784).

has limits on the number of directors that may be nominated.[100] According to the proposal, there may be one nominee if the board has eight or fewer directors, two nominees if the board has between nine and nineteen directors, and three nominees if the board has twenty or more directors.[101] A large shareholder, institutional investor, or shareholder group can represent the interests of minority shareholders in nominating directors. This process will allow a minority shareholder representative to sit on the board and represent minority shareholder interests.

Shareholders should be able to make changes to the corporate charter and amend the corporate bylaws. "Bylaws are the rules a corporation adopts to govern its internal affairs."[102] Bylaws deal with matters like the number of board directors, board vacancies, procedures for board meetings, special voting procedures, etc.[103] At early common law, only shareholders had the power to amend bylaws but today state statutes allow the shareholders to delegate this power to the board of directors.[104] If this power can be delegated to the board of directors, then shareholders should be able to require majority support for all proposed bylaw amendments. Furthermore, once a shareholder proposed by-

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[100] *Id.*
[101] *Id.* (citing 68 Fed. Reg. 60, 797).
[102] See Huchinson, supra note 61 at 1141.
[103] *Id.*
[104] *Id* at footnote 179 (Citing Steven Bainbridge, *Corporation Law and Economics*, at 43-45).

law receives majority support, the board of directors should be required to implement it. Specifically, shareholders should be able to elect and replace directors to ensure that value enhancing changes in the corporation will occur even if shareholders lack the power to initiate them.[105] By putting this power in the hands of the shareholders, management will not neglect shareholder interests and the shareholders will not need to exercise this power.[106]

The power to elect and replace directors is possibly the strongest tool to holding directors accountable. By changing the proxy and proposal rules discussed earlier in this paper, any shareholder who meets the qualifications will be able to enlist the help of larger shareholders. The ability to replace boards will motivate directors to make better decisions that will increase shareholder value.

Shareholders should have easier access to the courts to hold directors accountable for their business decisions. Procedural rules relating to shareholder suits for breaches of duty make it nearly impossible for shareholders to bring any action challenging director conduct.[107] Most states, including Delaware, require that a shareholder make demand on the board of directors asking the board to take suitable measures against the specific director.[108] The board assesses the

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[105] See Bebchuk, supra note 17, at 852.
[106] *Id.*
[107] See Fairfax, supra note 2, at 408.
[108] *Id.*

complaint and decides whether the corporation is going to take any action against the director.[109] Typically, the board chooses not to bring an action at all. If a shareholder decides to challenge this decision, courts will defer to the board because the board's decision is protected by the business judgment rule.[110] Fairfax makes the argument that although this procedure prevents frivolous suits, it undermines the shareholders ability to hold the director accountable.[111]

Demand on the board is said to be excused if the shareholder's complaint "creates a reasonable doubt that (1) the directors are disinterested and independent and (2) the challenged transaction is otherwise the product of a valid business judgment."[112] However, the board can appoint a special litigation committee of disinterested directors to assess the shareholders suit and subsequently make a motion to dismiss the suit on the committee's recommendation.[113] The conclusion to this process is that the board of directors determines whether suit against the board of directors will occur.[114]

Moreover, there are substantive rules protecting directors from all but the most egregious breaches of fiduciary duty. The dominate substantive barrier facing shareholders is the business judgment rule. The business judgment rule is

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[109] *Id.*
[110] *Id.*
[111] *Id.*
[112] *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984).
[113] See Fairfax, supra note 2, at 409.
[114] *Id.*

a presumption that a director or officer making a deliberative decision is reasonable informed, made reasonable inquiry, is acting in good faith, and has a rational basis for the business decision made.[115] In deciding whether or not directors have fulfilled their duty of care in a particular transaction, the business judgment rule permits judges to consider only the quality of the board's decision-making procedures.[116] Lynn Stout posits two attacks on the business judgment rule.[117] The first attack says that the business judgment rule does not discourage director carelessness.[118] The second attack argues that the business judgment rule creates incentives for directors to adopt costly decision making routines.[119] Each of these attacks cause delay and expense that harms the shareholder and the corporation.[120] This paper's proposal for granting shareholders easier access to the courts does not address every substantive barrier facing shareholders.[121] A full discussion of these barriers is beyond the scope of this paper, however easing

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[115] 473 A.2d at 812.

[116] Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkem and the Business Judgment Rule*, 96 Nw. U. L. Rev. 675 (2002).

[117] *Id.* at 676.

[118] *Id.*

[119] *Id.*

[120] *Id.*

[121] State law substantive barriers facing shareholders include the duty of loyalty along with the business judgment rule. There are also federal law substantive barriers such as Rule 10b-5 which make it all but impossible for a shareholder to prevail on a federal claim. However, a full discussion of this rule is also beyond the scope of this paper.

shareholder's procedural barriers will allow shareholders to focus more intently on the substantive ones.

Shareholders should not have to make demand on the board to hold directors accountable. If the demand requirement is removed, the board of directors will still be able to prevent suit if they have not breached their duty of care. The motion for summary judgment will allow directors to dismiss claims that have no issue of material fact. A director who has done nothing wrong has nothing to fear. Secondly, the expense of suing directors will alleviate most frivolous suits. Shareholders must have enough evidence to prove that the director actually breached a duty. If there is no evidence, the case will end when a 12(b)(6) motion is filed. If there is evidence, the case will either end with summary judgment or the director actually did breach a duty. The demand requirement is unnecessary insulation for an already over insulated board.

V. ARGUMENTS AGAINST GIVING THE SHAREHOLDER MORE CORPORATE CONTROL

Our current system of corporate governance has existed relatively unchanged for decades. The only changes made by the courts have been to increase director protection and decrease shareholder rights.[122] The accountability problem will be discussed first, followed by the argument that

[122] See Fairfax, supra note 2, at 394.

shareholders lack the knowledge to make proposals or initiate change, finally is the argument that minority shareholders do not care enough to make changes.

The first argument against giving shareholders more control in holding the directors accountable is the authority/accountability paradigm.[123] If shareholders are given more control, who is held responsible when a corporation fails? The answer to this question is simple, the directors will still be held responsible if the corporation fails because they make everyday corporate decisions. This paper is proposing that shareholders have the power to hold directors accountable for bad decisions. It is not proposing that shareholders should have more control in everyday corporate matters. The board of directors and corporate officers is still responsible for that. Shareholders need to be able to hold directors and officers accountable for the benefit of all stakeholders. If a shareholder or shareholder group introduces a proposal it will still need approval by a majority of shareholders. Furthermore, Bebchuck argues that the introduction of power for shareholders to intervene will encourage management to act differently to avoid shareholder intervention altogether.[124] Therefore, even

[123] See Hutchison, supra note 61 at 1193.
[124] See Bebchuk, supra note 17, at 878.

if the number of shareholder proposals does not increase, the lack of shareholder proposals could mean that the power is working.[125]

Shareholders do not have the knowledge to make good corporate decisions, which is why we have a board of directors. It is true that many shareholders do not know enough about business and corporate governance to make meaningful proposals that would benefit the corporation. Shareholders in this situation will likely defer to managements decision. In this situation, shareholders will be able to opt-out of the proposal and give their vote to a more suitable shareholder such as an institutional investor.

Public corporations have millions of shares owned by millions of people. This leads people to think that minority shareholders don't care as much because they do not have as much invested in the company. Since minority shareholders do not have as much invested, they are more willing to sell their shares. This is simply not true. The Enron and WorldCom scandals show how much small shareholders care about the corporation's success. When these companies had to restate their financial positions, their stock plummeted. Enron shareholders lost $179.3 billion when Enron filed for bankruptcy and WorldCom shareholders lost

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[125] *Id.*

over $66 billion.[126] Small shareholders who invested in that company cared about their loss. They did not have the ability to get their money back because Enron had none left. The Enron and WorldCom scandal show that small shareholders care about companies they invest in. Giving control to shareholders to initiate proposals, change corporate bylaws, and remove exculpatory provisions will allow smaller shareholders to protect their investment.

V. CONCLUSION

Giving shareholders more control in corporate governance will drastically increase a company's effectiveness. Directors in today's corporations can take actions which do not benefit shareholders and be protected from any action against them. The current director nominating process ensures that the incumbent board remains, even if certain directors act for personal interests instead of the interest of the corporation. A security holder nominating process permitting shareholders to elect directors lets shareholders put someone on the board to watch what other board members do and report back to the shareholders.

[126] Lisa M. Fairfax, *Form Over Substance?: Officer Certificaiton and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 Rutgers L Rev. 1, 9.

The demand requirement is unnecessary. It makes it nearly impossible for shareholders to hold directors accountable. The only purpose the demand requirement serves is to protect directors who make uninformed, bad decisions. A director who makes informed decisions, even if they are risky, does not have to fear liability.

Shareholders should be able to make corporate bylaw changes and changes to the corporate charter. The board of directors should be required to implement bylaw changes that receive support from a majority of shareholders. Admittedly, not all bylaw recommendations will be good ideas, but the proposed changes weed out bad or frivolous shareholder proposals. Shareholders will not propose bylaw amendments that harm themselves. Good proposals will remain and will receive majority support. The board's dislike of a proposal should not matter, because the board acts as mediating hierarchs. They act for the benefit of the corporation's shareholders and stakeholders, not for their own benefit.

This paper is not trying to reinvent the wheel. The corporate legal system currently in place may be the best available. However, a corporation's board of directors, whether interested or not, act for their own benefit. That is what people do. Shareholders act for the corporation's benefit because each shareholder has an interest in increasing the share price of the corporation. The

proposed measures support a board of directors acting as mediating hierarchs, not a board that acts in their own personal interests. Shareholders should be able to hold corporate officers and directors accountable for making decisions detrimental to the corporation and acting for personal gain instead of corporate gain.