

CHAPTER 6

PROBLEMS OF CONTROL

1. PROXY FIGHTS

INTRODUCTION

Corporations hold annual meetings of shareholders for election of directors and, where necessary, for voting on other matters. Corporations may also call special meetings—for example, for shareholder approval or disapproval of a merger. Despite the potential importance of actions taken at shareholder meetings, few shareholders of public corporations actually attend them. Few shareholders own enough shares to make any difference at the meeting, even institutional shareholders such as pension funds and mutual funds (though the role of such shareholders, despite various legal and other obstacles, seems to be moving toward greater involvement in corporate governance). Even if individuals own shares worth tens of thousands of dollars, their stake will generally be too small to affect the outcome. As a result, such shareholders seldom find it cost-effective to become well informed about corporate disputes, much less to attend any meeting in person.

Thus, most annual shareholder meetings are uneventful, quiet affairs, where directors are reelected without opposition and certain other routine matters are attended to. The events preceding such meetings can become contentious, however, if insurgents seek to take control of the firm by electing themselves and their allies to the board. Contention can also arise when issues that require shareholder approval are scheduled for determination at the annual meeting, or at a special meeting called to decide certain issues basic to the corporation. Such issues include whether to amend the articles of incorporation (for example, to limit director liability), to liquidate the firm, to sell all or substantially all of the assets, or to engage in a merger.

With small firms, by contrast, shareholders may appear at the meeting and help decide the firm's business strategy. Shareholders of such firms may find it worthwhile to attend shareholder meetings because they own enough shares to affect the outcome of any vote.

Because few shareholders of public corporations attend the annual meeting, the outcome will generally depend on which group has collected the most "proxies." (Proxy voting is also available, but less common, for small corporations.) Under corporate law, shareholders may appoint an agent to attend the meeting and vote on their behalf. That agent is the shareholder's "proxyholder," sometimes simply called the shareholder's "proxy"; the document by which the shareholder appoints the agent is also called the "proxy" (or "proxy card"). Because the outcome of the

meeting depends on the number of votes cast, the person with the most proxies usually wins.

Generally, the incumbent managers of a large firm will solicit proxies from shareholders directly. Shortly before the annual meeting, they will write to the "shareholders of record" and ask them to sign and return the enclosed proxy card. By doing so, the shareholders authorize the management representative to vote on their behalf. If the stock is held in "street name," the broker or bank will forward the material to the "beneficial owner."*

"Proxy fights" result when an insurgent group tries to oust incumbent managers by soliciting proxy cards and electing its own representatives to the board. Such fights were relatively common in the 1950s, but fell out of favor when insurgent investors turned to tender offers as a more efficient way to gain corporate control. In the 1980s and 1990s, however, many corporations adopted defenses against tender offers and many states passed statutes that increased the difficulty and reduced the cost-effectiveness of tender offers. (On all of these developments, see Chapter 7, Sec. 2). Accordingly, insurgent shareholders again be turned to proxy fights, but now typically as part of a larger tender offer effort. An insurgent group could initiate a tender offer, for example, but combine it with a proxy fight to put added pressure on the incumbents. It might try to replace the existing board through the proxy fight, or use the proxies to fight any defensive measures that the management hopes to implement. Like tender offers, proxy fights are subject both to the 1934 Securities Exchange Act and to state corporate statutes.

A. STRATEGIC USE OF PROXIES

Levin v. Metro-Goldwyn-Mayer, Inc.

264 F.Supp. 797 (S.D.N.Y.1967).

This action was filed by six stockholders of Metro-Goldwyn-Mayer, Inc. (MGM), a Delaware corporation with its principal place of business in New York.** The defendants named are MGM and five of the thirteen members of its Board of Directors. They are part of present MGM

* Traditionally, an investor who bought stock notified the company and recorded the stock in his or her own name. Before the annual meeting, the board of directors would announce a given date as the "record date" for the meeting (or the by-laws would specify a date). People listed on the corporation's stock ledger as owning the stock on that date were called the "shareholders of record" and, even if they thereafter sold the stock before the meeting, were the people entitled to vote at the meeting. In part to facilitate trades, however, many shareholders no longer bother to notify the company when they purchase. Instead, they simply leave the stock in the name of their broker (or depository trust company). Such stock is said to be held "in street name," and the investor is known as the "beneficial owner."

** [Eds.—Jurisdiction was based both on diversity and on a federal cause of action arising out of alleged SEC proxy rule violations.]

corporate management; all of them serve as officers or as members of the Executive Committee.

Plaintiff, Philip Levin, is and has been a director of MGM since February, 1965 and all of the plaintiffs hold substantial blocks of MGM common stock.³

The present action flows from a conflict for corporate control between present management—called “the O’Brien group” and “the Levin group.” Each group intends to nominate a slate of directors at the MGM stockholder annual meeting which is to be held on February 23, 1967; each has been actively soliciting proxies for this meeting. . . .

Plaintiffs complain of the manner, method and means employed by defendants in the solicitation of proxies for the coming annual meeting of MGM stockholders. Specifically, plaintiffs charged that the defendants, in connection with the proxy solicitation contest, have wrongfully committed MGM to pay for the services of specially retained attorneys, a public relations firm and proxy soliciting organizations, and, in addition, have improperly used the offices and employees of MGM in proxy solicitation and the good-will and business contacts of MGM to secure support for the present management. Plaintiffs, in their complaint, pray for temporary and permanent injunctive relief against defendants’ continuing this method of solicitation of proxies and against defendants’ voting the proxies so obtained at the annual meeting. They also seek money damages of \$2,500,000 on behalf of MGM from the individual defendants. . . .

Plaintiffs maintain the injunctive relief sought is required to prevent (1) the unlawful use of the corporate organization—its employees, good-will and offices and of corporate funds in the solicitation of proxies, (2) the retention of “the four top proxy-soliciting concerns and the passing of their bill for their services to the corporation rather than to the individuals” and (3) the employment at corporate expense of special counsel “for the sole and exclusive and no other purpose than the waging of a proxy contest on behalf of the individual defendants who have every right to pay for his valuable services” with their own private funds, particularly in view of the fact that regularly employed attorneys are available to represent the corporate interests of MGM.

Because of the nature of plaintiffs’ allegations, we weigh the merits of this application for injunctive relief against the financial and business background of MGM. As of August 31, 1966, MGM had total assets of \$251,132,000 and a gross income for its 1966 fiscal year of approximately \$185,000,000. It is one of the major producers and distributors of motion pictures in the world and markets to exhibitors films produced by others

³ Plaintiffs own 552,705 shares of MGM common stock, approximately 11% of the total outstanding shares, with a market value of nearly \$20,000,000. Levin, one of the plaintiffs, also states by affidavit that he has other stockholders associated with him in the proxy contest who hold 127,150 shares of MGM common, with a market value of approximately \$4,323,100.

as well as its own films. . . . MGM is one of the "giants" in the entertainment industry.

. . . Defendants point with unabashed pride to the results they have achieved in their direction of the affairs of MGM. We do not question that the successful operation of MGM has been accomplished in no small measure by diligent and intelligent application to corporate affairs and by the exercise of sound and informed business judgment. The decision as to the continuance of the present management, however, rests entirely with the stockholders. A court may not override or dictate on a matter of this nature to stockholders.

. . . It is the concern of the law and of the Court that they be fully and truthfully informed as to the merits of the contentions of those soliciting their proxy. It is equally important that the Court should not unnecessarily exercise its injunctive power in such matters lest such judicial action operate to unduly influence a stockholder's decision as to which faction should receive his proxy.

It is quite plain that the differences between "the O'Brien group" and "the Levin group" are much more than mere personality conflicts. These might readily be resolved by reasoning and hard-headed, profit-minded business men. There are definite business policies advocated by each group, so divergent that reconciliation does not seem possible. They appear so evident from the papers before us that detailed analysis would be a waste of time.⁷ However, in such a situation the right of an independent stockholder to be fully informed is of supreme importance. The controlling question presented on this application is whether illegal or unfair means of communication, such as demand judicial intervention, are being employed by the present management. We find that they are not and conclude that the injunctive relief now sought should be denied.

The proxy statement filed by MGM under date of January 6, 1967, opens with the statement that "MGM will bear all cost in connection with the management solicitation of proxies." . . . It discloses the employment of Georgeson & Co. at \$15,000 and Kissel-Blake Organization, Inc. at \$5,000 for services and estimated out-of-pocket expenses. . . .

It advises that "Proxies may also be solicited in newspapers or other publications" and that the total amount which it is estimated will be spent in the management solicitation is \$125,000 "exclusive of amounts

⁷ The fundamental policy differences between the contesting groups concern, among other matters:

- a. The annual number of feature pictures MGM should produce; management policy would limit them to approximately 25 top productions (with cost per picture from \$5,000,000 to \$8,000,000) and the balance costing down to approximately \$500,000; "the Levin group" policy advocates up to 50 top productions a year.
- b. "The Levin" policy would provide for a slow release of pictures to TV showing; management would license to TV pictures of more recent release date. . . .
- d. Levin policy would build up cash funds available for productions by reducing dividends, and thus reduce necessity for financing; present management policy is different.

normally expended for a solicitation for an election of directors and costs represented by salaries and wages of regular employees and officers."

We do not find the amounts recited to be paid excessive, or the method of operation disclosed by MGM management to be unfair or illegal. It contravenes no federal statute or S.E.C. rule or regulation. . . .

Motion denied.

PROBLEM

Suppose you own 25 percent of the stock of True Love, Inc., a publisher of gothic romance novels. On the supposition that the novel market is shrinking, True Love has decided to start a new division, Amore Comics, to produce gothic romance comic books. You believe that the Amore Comics venture is doomed, and launch a proxy fight to install yourself and your literati friends on the board. Incumbent managers fight back by using corporate funds to hire a public relations firm that will mastermind their tactics.

You file a derivative suit challenging that use of the corporate treasury. What result? How would your answer change if you establish that 80 percent of the stock of the public relations firm is held by the older brother of the True Love CEO? What if you could also establish that three of the eleven True Love directors are personal friends of Lady Lucy Duff Gordon, the illustrator retained to draw the Amore Comics?

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B. REIMBURSEMENT OF COSTS

Rosenfeld v. Fairchild Engine & Airplane Corp.

309 N.Y. 168, 128 N.E.2d 291 (1955).

■ FROESSEL, JUDGE.

In a stockholder's derivative action brought by plaintiff, an attorney, who owns 25 out of the company's over 2,300,000 shares, seeks to compel the return of \$261,522, paid out of the corporate treasury to reimburse both sides in a proxy contest for their expenses. The Appellate Division, . . . has unanimously affirmed a judgment of an Official Referee, . . . dismissing plaintiff's complaint on the merits, and we agree. . . .

Of the amount in controversy \$106,000 was spent out of corporate funds by the old board of directors while still in office in defense of their position in said contest; \$28,000 was paid to the old board by the new board after the change of management following the proxy contest, to compensate the former directors for such of the remaining expenses of their unsuccessful defense as the new board found was fair and reasonable; payment of \$127,000, representing reimbursement of expenses to members of the prevailing group, was expressly ratified by a 16 to 1 majority vote of the stockholders.

... The Appellate Division found that the difference between plaintiff's group and the old board "went deep into the policies of the company", and that among these Ward's contract was one of the "main points of contention."

By way of contrast with the findings here, in *Lawyers' Advertising Co. v. Consolidated Ry., Lighting & Refrigerating Co.*, 187 N.Y. 395, ... which was an action to recover for the cost of publishing newspaper notices not authorized by the board of directors, it was expressly found that the proxy contest there involved was "by one faction in its contest with another for the control of the corporation ... a contest for the perpetuation of their offices and control." We there said by way of dicta that under such circumstances the publication of certain notices on behalf of the management faction was not a corporate expenditure which the directors had the power to authorize.

Other jurisdictions and our own lower courts have held that management may look to the corporate treasury for the reasonable expenses of soliciting proxies to defend its position in a bona fide policy contest. ...

It should be noted that plaintiff does not argue that the aforementioned sums were fraudulently extracted from the corporation; indeed, his counsel conceded that "the charges were fair and reasonable," but denied "they were legal charges which may be reimbursed for." ...

If directors of a corporation may not in good faith incur reasonable and proper expenses in soliciting proxies in these days of giant corporations with vast numbers of stockholders, the corporate business might be seriously interfered with because of stockholder indifference and the difficulty of procuring a quorum, where there is no contest. In the event of a proxy contest, if the directors may not freely answer the challenges of outside groups and in good faith defend their actions with respect to corporate policy for the information of the stockholders, they and the corporation may be at the mercy of persons seeking to wrest control for their own purposes, so long as such persons have ample funds to conduct a proxy contest. The test is clear. When the directors act in good faith in a contest over policy, they have the right to incur reasonable and proper expenses for solicitation of proxies and in defense of their corporate policies, and are not obliged to sit idly by. ...

It is also our view that the members of the so-called new group could be reimbursed by the corporation for their expenditures in this contest by affirmative vote of the stockholders. ...

The rule then which we adopt is simply this: In a contest over policy, as compared to a purely personal power contest, corporate directors have the right to make reasonable and proper expenditures, subject to the scrutiny of the courts when duly challenged, from the corporate treasury for the purpose of persuading the stockholders of the correctness of their position and soliciting their support for policies which the directors

believe, in all good faith, are in the best interests of the corporation. The stockholders, moreover, have the right to reimburse successful contestants for the reasonable and bona fide expenses incurred by them in any such policy contest, subject to like court scrutiny. That is not to say, however, that corporate directors can, under any circumstances, disport themselves in a proxy contest with the corporation's moneys to an unlimited extent. Where it is established that such moneys have been spent for personal power, individual gain or private advantage, and not in the belief that such expenditures are in the best interests of the stockholders and the corporation, or where the fairness and reasonableness of the amounts allegedly expended are duly and successfully challenged, the courts will not hesitate to disallow them.

The judgment of the Appellate Division should be affirmed, without costs.

■ VAN VOORHIS, JUDGE (dissenting).

...
No resolution was passed by the stockholders approving payment to the management group. It has been recognized that not all of the \$133,966 in obligations paid or incurred by the management group was designed merely for information of stockholders. This outlay included payment for all of the activities of a strenuous campaign to persuade and cajole in a hard-fought contest for control of this corporation. It included, for example, expenses for entertainment, chartered airplanes and limousines, public relations counsel and proxy solicitors. However legitimate such measures may be on behalf of stockholders themselves in such a controversy, most of them do not pertain to a corporate function but are part of the familiar apparatus of aggressive factions in corporate contests. ...

The Appellate Division acknowledged in the instant case that "It is obvious that the management group here incurred a substantial amount of needless expense which was charged to the corporation," but this conclusion should have led to a direction that those defendants who were incumbent directors should be required to come forward with an explanation of their expenditures under the familiar rule that where it has been established that directors have expended corporate money for their own purposes, the burden of going forward with evidence of the propriety and reasonableness of specific items rests upon the directors. ...

The second ground assigned by the Appellate Division for dismissing the complaint against incumbent directors is stockholder ratification of the reimbursement to the insurgent group. Whatever effect or lack of it this resolution had upon expenditures by the insurgent group, clearly the stockholders who voted to pay the insurgents entertained no intention of reimbursing the management group for their expenditures. ... Upon the contrary, they were removing the incumbents from control mainly for the

reason that they were charged with having mulcted the corporation by a long-term salary and pension contract to one of their number, J. Carlton Ward, Jr. . . .

What expenses of the incumbent group should be allowed and what should be disallowed should be remitted to the trial court to ascertain, after taking evidence, in accordance with the rule that the incumbent directors were required to assume the burden of going forward in the first instance with evidence explaining and justifying their expenditures. Only such as were reasonably related to informing the stockholders fully and fairly concerning the corporate affairs should be allowed. The concession by plaintiff that such expenditures as were made were reasonable in amount does not decide this question. By way of illustration, the costs of entertainment for stockholders may have been, and it is stipulated that they were, at the going rates for providing similar entertainment. That does not signify that entertaining stockholders is reasonably related to the purposes of the corporation. . . .

Regarding the \$127,556 paid by the new management to the insurgent group for their campaign expenditures, the question immediately arises whether that was for a corporate purpose. The Appellate Division has recognized that upon no theory could such expenditures be reimbursed except by approval of the stockholders and, as has been said, it is the insurgents' expenditures alone to which the stockholders' resolution of ratification was addressed. If *unanimous* stockholder approval had been obtained and no rights of creditors or of the public intervened, it would make no practical difference whether the purpose were *ultra vires*—i.e., not a corporate purpose. . . . Upon the other hand, an act which is *ultra vires* cannot be ratified merely by a majority of the stockholders of a corporation.

The . . . cases which are cited consist of *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 20 Del.Ch. 78, 171 A. 226, . . . and the Federal cases applying Delaware law, *Hand v. Missouri-Kansas Pipe Line Co.*, D.C., 54 F.Supp. 649, and *Steinberg v. Adams*, [90 F.Supp. 604]. . . .

The case most frequently cited and principally relied upon from among these Delaware decisions is *Hall v. Trans-Lux Daylight Picture Screen Corp.*, supra. There the English case was followed of *Peel v. London & North Western Ry. Co.*, [1 Ch. 5 (1907)], which distinguished between expenses merely for the purpose of maintaining control, and contests over policy questions of the corporation. In the *Hall* case the issues concerned a proposed merger, and a proposed sale of stock of a subsidiary corporation. These were held to be policy questions, and payment of the management campaign expenses was upheld.

In our view, the impracticability of such a distinction is illustrated by the statement in the *Hall* case, . . . that "It is impossible in many cases of intracorporate contests over directors, to sever questions of policy from those of persons." This circumstance is stressed in Judge Rifkind's opinion in the *Steinberg* case . . .

"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."

That may be all very well, but the upshot of this reasoning is that inasmuch as it is generally impossible to distinguish whether "policy" or "personnel" is the dominant factor, any averments must be accepted at their face value that questions of policy are dominant. Nowhere do these opinions mention that the converse is equally true and more pervasive, that neither the "ins" nor the "outs" ever say that they have no program to offer to the shareholders, but just want to acquire or to retain control, as the case may be. In common experience, this distinction is unreal. . . .

The main question of "policy" in the instant corporate election, as is stated in the opinions below and frankly admitted, concerns the long-term contract with pension rights of a former officer and director, Mr. J. Carlton Ward, Jr. The insurgents' chief claim of benefit to the corporation from their victory consists in the termination of that agreement, resulting in an alleged actuarial saving of \$350,000 to \$825,000 to the corporation, and the reduction of other salaries and rent by more than \$300,000 per year. The insurgents had contended in the proxy contest that these payments should be substantially reduced so that members of the incumbent group would not continue to profit personally at the expense of the corporation. If these charges were true, which appear to have been believed by a majority of the shareholders, then the disbursements by the management group in the proxy contest fall under the condemnation of the English and the Delaware rule.

These circumstances are mentioned primarily to illustrate how impossible it is to distinguish between "policy" and "personnel," as Judge Rifkind expressed it, but they also indicate that personal factors are deeply rooted in this contest. That is certainly true insofar as the former management group is concerned. It would be hard to find a case to which the careful reservation made by the English Judge in the *Peel* case, *supra*, was more directly applicable.

NOTES ON THE REGULATION OF PROXY FIGHTS

1. *The Regulatory Scheme:* Section 14(a) of the 1934 Act prohibits people from soliciting proxies in violation of SEC rules. Consider the scope of this statement. First, courts construe the concept of "solicitation" broadly. In *Studebaker Corp. v. Gittlin*, 360 F.2d 692 (2d Cir.1966), for example, an insurgent shareholder planned to solicit proxies from the other shareholders, and for that purpose wanted access to the list of the firm's shareholders. Because he held insufficient shares to demand the list under state law, he asked some other shareholders to join him in his effort. The court held that these preliminary requests constituted a proxy solicitation—he solicited proxies when he asked selected shareholders to join him in demanding the shareholder list, even though his purpose in

getting the list was *then* to ask the shareholders for their proxies for the annual meeting. In 1992, however, the SEC amended Rule 14a-2 to specify that a shareholder does not (subject to several qualifications) fall under the general SEC filing requirements if it does not solicit proxies for itself. A pension fund that submits a shareholder proposal, for example, may not be subject to the requirements since, even if it campaigns on behalf of its proposal, it is not asking shareholders to give it proxies.

Second, the rules require people who solicit proxies to furnish each shareholder with a "proxy statement." In it, they must disclose information that may be relevant to the decision the shareholder must make. Generally, for example, the management must include an annual report, and anyone soliciting the proxies must disclose conflicts of interest and any major issues he or she expects to raise at the shareholder meeting. In the case of proxies for contested meetings, the rules require particularly extensive disclosure. Under Rule 14a-6, the parties soliciting the proxies must file copies of this material with the SEC.

Third, when an insurgent group wants to contest management and solicit proxies, Rule 14a-7 gives management a choice: it can either mail the insurgent group's material to the shareholders directly and charge the group for the cost, or it can give the group a copy of the shareholder list and let it distribute its own material. Because the management often prefers to keep the list confidential, it generally opts for the former. Naturally, if the insurgent has a right to the shareholders list under state law (as discussed in several cases below), Rule 14a-7 does not circumscribe that right.

2. *The economics of proxy fights:* Proxy fights fell out of favor in corporate control contests for simple economic reasons: if an insurgent group organized a proxy fight and lost, it bore the entire cost of soliciting the proxies; if it won and made the firm more profitable, it gained only a fraction of that increased profitability. To see the point, suppose you own 10 percent of a firm worth \$8 million (\$800,000), but believe it to be badly managed. You conclude that by firing the managers, you could raise the value of the firm by 20 percent (or \$1.6 million). Your lawyer tells you that you could replace the managers in two ways: (a) you could organize a tender offer, buy up all the stock, and then replace the directors, or (b) you could solicit proxies from the existing shareholders and elect new directors. Of these two, the tender offer will almost always require a larger outlay. Because you will buy the stock itself, you will need at least \$7.2 million (for 90 percent of the stock of an \$8 million company). If you do so, however, you will capture all of the gains from any improvement you make to the company. (You could, of course, simply buy another 41 percent of the stock and gain majority control. You would then, however, capture only half of any increased profitability you generate.)

By contrast, suppose you organize a proxy fight. If you succeed, your stock will rise by only \$160,000 (20% of your \$800,000 investment). True, if you succeed, the firm may reimburse you for your proxy expenses. If you fail, though, you bear the entire cost of the proxy fight. As a result, you bear large risks, but stand to earn only a small portion of any gains you create. More generally, the point is this: investors who expect to incur large financial risks in rehabilitating a badly managed firm will prefer to keep for themselves any increased value they create. With a tender offer, they can buy all the corporate stock and do so. With a proxy fight, they must share that value with the other shareholders.

3. Statutory reform in Delaware re expenses: In 2009, the Delaware legislature adopted new Delaware General Corporation Law § 113, which states that:

(a) The bylaws may provide for the reimbursement by the corporation of expenses incurred by a stockholder in soliciting proxies in connection with an election of directors, subject to such procedures or conditions as the bylaws may prescribe, including:

(1) Conditioning eligibility for reimbursement upon the number or proportion of persons nominated by the stockholder seeking reimbursement or whether such stockholder previously sought reimbursement for similar expenses;

(2) Limitations on the amount of reimbursement based upon the proportion of votes cast in favor of 1 or more of the persons nominated by the stockholder seeking reimbursement, or upon the amount spent by the corporation in soliciting proxies in connection with the election;

(3) Limitations concerning elections of directors by cumulative voting pursuant to § 214 of this title; or

(4) Any other lawful condition.

(b) No bylaw so adopted shall apply to elections for which any record date precedes its adoption.

Section 113 was adopted following the Delaware Supreme Court's decision in *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008).

QUESTIONS

1. In order to find an inefficiently managed firm, a potential insurgent group will need to investigate many firms. Under *Rosenfeld*, it may be compensated for the cost of a proxy fight if it wins. Yet it will not be compensated either for the cost of investigating firms that it discovers

are properly managed, or for the cost of proxy fights it loses. How does this affect the incentive to renovate inefficiently managed firms?

2. As a matter of policy, should a successful insurgent group receive a multiple of its expenses to compensate it for the proxy fights it loses? For the cost of investigating firms that it discovers are properly managed? Should it be compensated directly for proxy fights it loses?

3. If insurgent groups are reimbursed only when they win, should incumbents be reimbursed when they lose?

PROBLEM

Kane is a rich man who likes to run newspapers. He is the editor-in-chief of the New York *Inquirer* and CEO and 33 percent owner of the *Inquirer* Corp., the parent firm. Geddes owns 10 percent of the *Inquirer* Corp. and thinks he himself would make a better CEO and editor. He decides to launch a proxy fight.

Kane throws a lavish party at Xanadu, his country estate, for the lead shareholders (assorted managers of pension funds and mutual funds). He gives a short lecture about why the status quo should continue, and then invites everyone to party until dawn. Can Kane charge his expenses to the company?

Geddes throws a lean-and-mean party aboard his yacht, the *Geddes Princess*, at which he harangues the same lead shareholders about Kane's mismanagement and about his own ability to run a newspaper. Can Geddes obtain reimbursement from the *Inquirer* Corp. if he wins? If he loses?

C. PRIVATE ACTIONS FOR PROXY RULE VIOLATIONS

J.I. Case Co. v. Borak

377 U.S. 426, 84 S.Ct. 1555, 12 L.Ed.2d 423 (1964).

This is a civil action brought by respondent, a stockholder of petitioner J. I. Case Company, charging [that] a merger between Case and the American Tractor Corporation . . . was effected through the circulation of a false and misleading proxy statement by those proposing the merger. The complaint . . . alleged a violation of § 14(a)¹ of the Securities Exchange Act of 1934 with reference to the proxy solicitation material. The trial court held that as to this count it had no power to redress the alleged violations of the Act but was limited solely to the

¹ Section 14(a) of the Securities Exchange Act of 1934, 48 Stat. 895, 15 U.S.C. § 78n(a), provides: 'It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the (Securities and Exchange) Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.'

granting of declaratory relief thereon under § 27 of the Act.² On interlocutory appeal the Court of Appeals reversed. . . . We consider only the question of whether § 27 of the Act authorizes a federal cause of action for rescission or damages to a corporate stockholder with respect to a consummated merger which was authorized pursuant to the use of a proxy statement alleged to contain false and misleading statements violative of § 14(a) of the Act. . . .

I.

Respondent, the owner of 2,000 shares of common stock of Case acquired prior to the merger, brought this suit based on diversity jurisdiction seeking the enjoin a proposed merger between Case and the American Tractor Corporation (ATC) on various grounds, including breach of the fiduciary duties of the Case directors, self-dealing among the management of Case and ATC and misrepresentations contained in the material circulated to obtain proxies. The injunction was denied and the merger was thereafter consummated. Subsequently successive amended complaints were filed. . . . They alleged: that petitioners, or their predecessors, solicited or permitted their names to be used in the solicitation of proxies of Case stockholders for use at a special stockholders' meeting at which the proposed merger with ATC was to be voted upon; that the proxy solicitation material so circulated was false and misleading in violation of § 14(a) of the Act and Rule 14a-9 which the Commission had promulgated thereunder;⁴ that the merger was approved at the meeting by a small margin of votes and was thereafter consummated; that the merger would not have been approved but for the false and misleading statements in the proxy solicitation material; and that Case stockholders were damaged thereby. The respondent sought judgment holding the merger void and damages for himself and all other stockholders similarly situated, as well as such further relief 'as equity shall require.' . . .

² Section 27 of the Act, 48 Stat. 902-903, 15 U.S.C. § 78aa, provides in part: 'The district courts of the United States, the Supreme Court of the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or to enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.'

⁴ 17 CFR s 240.14a-9 provides: 'False or misleading statements. No solicitation subject to §§ 240.14a-1 to 240.14a-10 shall be made by means of any proxy statement, form of proxy, notice of meeting, or other communication written or oral containing any statement which at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct an statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.'

II.

It appears clear that private parties have a right under § 27 to bring suit for violation of § 14(a) of the Act. Indeed, this section specifically grants the appropriate District Courts jurisdiction over "all suits in equity and actions at law brought to enforce any liability or duty created under the Act. The petitioners make no concessions, however, emphasizing that Congress made no specific reference to a private right of action in § 14(a); that, in any event, the right would not extend to derivative suits and should be limited to prospective relief only. In addition, some of the petitioners argue that the merger can be dissolved only if it was fraudulent or non-beneficial, issues upon which the proxy material would not bear. But the causal relationship of the proxy material and the merger are questions of fact to be resolved at trial, not here. We therefore do not discuss this point further.

III.

While the respondent contends that his Count 2 claim is not a derivative one, we need not embrace that view, for we believe that a right of action exists as to both derivative and direct causes.

The purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation. The section stemmed from the congressional belief that "(f)air corporate suffrage is an important right that should attach to every equity security bought on a public exchange." H.R. Rep. No. 1383, 73d Cong., 2d Sess., 13. It was intended to "control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which * * * (had) frustrated the free exercise of the voting rights of stockholders." Id., at 14. "Too often proxies are solicited without explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought." S. Rep. No. 792, 73d Cong., 2d Sess., 12. These broad remedial purposes are evidenced in the language of the section which makes it "unlawful for any person * * * to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security * * * registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." While this language makes no specific reference to a private right of action, among its chief purposes is "the protection of investors," which certainly implies the availability of judicial relief where necessary to achieve that result.

The injury which a stockholder suffers from corporate action pursuant to a deceptive proxy solicitation ordinarily flows from the damage done the corporation, rather than from the damage inflicted directly upon the stockholder. The damage suffered results not from the deceit practiced on him alone but rather from the deceit practiced on the stockholders as a group. To hold that derivative actions are not within

the sweep of the section would therefore be tantamount to a denial of private relief. Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in anti-trust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements. The Commission advises that it examines over 2,000 proxy statements annually and each of them must necessarily be expedited. Time does not permit an independent examination of the facts set out in the proxy material and this results in the Commission's acceptance of the representations contained therein at their face value, unless contrary to other material on file with it. Indeed, on the allegations of respondent's complaint, the proxy material failed to disclose alleged unlawful market manipulation of the stock of ATC, and this unlawful manipulation would not have been apparent to the Commission until after the merger.

We, therefore, believe that under the circumstances here it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose. . . . It is for the federal courts "to adjust their remedies so as to grant the necessary relief" where federally secured rights are invaded. "And it is also well settled that where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done." *Bell v. Hood*, 327 U.S. 678, 684, 66 S.Ct. 773, 777, 90 L.Ed. 939 (1946). Section 27 grants the District Courts jurisdiction "of all suits in equity and actions at law brought to enforce any liability or duty created by this title * * *."

"The power to enforce implies the power to make effective the right of recovery afforded by the Act. And the power to make the right of recovery effective implies the power to utilize any of the procedures or actions normally available to the litigant according to the exigencies of the particular case." [*Deckert v. Independence Shares Corp.*, 311 U.S. 282, 288 (1940).]

...

Nor do we find merit in the contention that such remedies are limited to prospective relief. . . . [I]f federal jurisdiction were limited to the granting of declaratory relief, victims of deceptive proxy statements would be obliged to go into state courts for remedial relief. And if the law of the State happened to attach no responsibility to the use of misleading proxy statements, the whole purpose of the section might be frustrated. Furthermore, the hurdles that the victim might face (such as . . . security for expenses statutes . . . , etc.) might well prove insuperable to effective relief.

IV.

Our finding that federal courts have the power to grant all necessary remedial relief is not to be construed as any indication of what we believe to be the necessary and appropriate relief in this case. We are concerned

here only with a determination that federal jurisdiction for this purpose does exist. Whatever remedy is necessary must await the trial on the merits.

The other contentions of the petitioners are denied.

Affirmed.

ANALYSIS

Nothing in the Securities Exchange Act or the SEC rules thereunder creates an express cause of action for shareholders suing over proxy violations. What then was the statutory basis for finding a federal cause of action?

Mills v. Electric Auto-Lite Co.

396 U.S. 375, 90 S.Ct. 616, 24 L.Ed.2d 593 (1970).

This case requires us to consider a basic aspect of the implied private right of action for violation of § 14(a) of the Securities Exchange Act of 1934, recognized by this Court in *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964). As in *Borak* the asserted wrong is that a corporate merger was accomplished through the use of a proxy statement that was materially false or misleading. The question with which we deal is what causal relationship must be shown between such a statement and the merger to establish a cause of action based on the violation of the Act.

I

Petitioners were shareholders of the Electric Auto-Lite Company until 1963, when it was merged into Mergenthaler Linotype Company. They brought suit on the day before the shareholders' meeting at which the vote was to take place on the merger against Auto-Lite, Mergenthaler, and a third company, American Manufacturing Company, Inc. The complaint sought an injunction against the voting by Auto-Lite's management of all proxies obtained by means of an allegedly misleading proxy solicitation; however, it did not seek a temporary restraining order, and the voting went ahead as scheduled the following day. Several months later petitioners filed an amended complaint, seeking to have the merger set aside and to obtain such other relief as might be proper.

In Count II of the amended complaint, which is the only count before us,² petitioners predicated jurisdiction on § 27 of the 1934 Act. They alleged that the proxy statement sent out by the Auto-Lite management to solicit shareholders' votes in favor of the merger was misleading, in violation of § 14(a) of the Act and SEC Rule 14a-9 thereunder. Petitioners recited that before the merger Mergenthaler owned over 50% of the outstanding shares of Auto-Lite common stock, and had been in control of Auto-Lite for two years. American Manufacturing in turn

² In the other two counts, petitioners alleged common-law fraud and that the merger was ultra vires under Ohio law.

owned about one-third of the outstanding shares of Mergenthaler, and for two years had been in voting control of Mergenthaler and, through it, of Auto-Lite. Petitioners charged that in light of these circumstances the proxy statement was misleading in that it told Auto-Lite shareholders that their board of directors recommended approval of the merger without also informing them that all 11 of Auto-Lite's directors were nominees of Mergenthaler and were under the 'control and domination of Mergenthaler.' Petitioners asserted the right to complain of this alleged violation both derivatively on behalf of Auto-Lite and as representatives of the class of all its minority shareholders.

On petitioners' motion for summary judgment with respect to Count II, the District Court for the Northern District of Illinois ruled as a matter of law that the claimed defect in the proxy statement was, in light of the circumstances in which the statement was made, a material omission. The District Court concluded, from its reading of the *Borak* opinion, that it had to hold a hearing on the issue whether there was "a causal connection between the finding that there has been a violation of the disclosure requirements of § 14(a) and the alleged injury to the plaintiffs" before it could consider what remedies would be appropriate.

After holding such a hearing, the court found that under the terms of the merger agreement, an affirmative vote of two-thirds of the Auto-Lite shares was required for approval of the merger, and that the respondent companies owned and controlled about 54% of the outstanding shares. Therefore, to obtain authorization of the merger, respondents had to secure the approval of a substantial number of the minority shareholders. At the stockholders' meeting, approximately 950,000 shares, out of 1,160,000 shares outstanding, were voted in favor of the merger. This included 317,000 votes obtained by proxy from the minority shareholders, votes that were 'necessary and indispensable to the approval of the merger.' The District Court concluded that a causal relationship had thus been shown. . . .

[R]espondents took an interlocutory appeal to the Court of Appeals for the Seventh Circuit. That court affirmed the District Court's conclusion that the proxy statement was materially deficient, but reversed on the question of causation. The court acknowledged that, if an injunction had been sought a sufficient time before the stockholders' meeting, "corrective measures would have been appropriate." However, since this suit was brought too late for preventive action, the courts had to determine "whether the misleading statement and omission caused the submission of sufficient proxies," as a prerequisite to a determination of liability under the Act. If the respondents could show, "by a preponderance of probabilities, that the merger would have received a sufficient vote even if the proxy statement had not been misleading in the respect found," petitioners would be entitled to no relief of any kind.

The Court of Appeals acknowledged that this test corresponds to the common-law fraud test of whether the injured party relied on the

misrepresentation. However, rightly concluding that "[r]eliance by thousands of individuals, as here, can scarcely be inquired into," the court ruled that the issue was to be determined by proof of the fairness of the terms of the merger. If respondents could show that the merger had merit and was fair to the minority shareholders, the trial court would be justified in concluding that a sufficient number of shareholders would have approved the merger had there been no deficiency in the proxy statement. In that case respondents would be entitled to a judgment in their favor.

Claiming that the Court of Appeals has construed this Court's decision in *Borak* in a manner that frustrates the statute's policy of enforcement through private litigation, the petitioners then sought review in this Court.

II

As we stressed in *Borak*, § 14(a) stemmed from a congressional belief that "[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange." H.R. Rep. No. 1383, 73d Cong., 2d Sess., 13. The provision was intended to promote "the free exercise of the voting rights of stockholders" by ensuring that proxies would be solicited with "explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought." *Id.* at 14. The decision below, by permitting all liability to be foreclosed on the basis of a finding that the merger was fair, would allow the stockholders to be by-passed, at least where the only legal challenge to the merger is a suit for retrospective relief after the meeting has been held. A judicial appraisal of the merger's merits could be substituted for the actual and informed vote of the stockholders.

The result would be to insulate from private redress an entire category of proxy violations—those relating to matters other than the terms of the merger. Even outrageous misrepresentations in a proxy solicitation, if they did not relate to the terms of the transaction, would give rise to no cause of action under § 14(a). Particularly if carried over to enforcement actions by the Securities and Exchange Commission itself, such a result would subvert the congressional purpose of ensuring full and fair disclosure to shareholders.

Further, recognition of the fairness of the merger as a complete defense would confront small shareholders with an additional obstacle to making a successful challenge to a proposal recommended through a defective proxy statement. The risk that they would be unable to rebut the corporation's evidence of the fairness of the proposal, and thus to establish their cause of action, would be bound to discourage such shareholders from the private enforcement of the proxy rules that "provides a necessary supplement to Commission action." *J. I. Case Co. v. Borak*, 377 U.S., at 432, 84 S.Ct. at 1560.

... In *Borak*, which came to this Court on a dismissal of the complaint, the Court limited its inquiry to whether a violation of § 14(a) gives rise to "a federal cause of action for rescission or damages," 377 U.S., at 428, 84 S.Ct. at 1558. Referring to the argument made by petitioners there "that the merger can be dissolved only if it was fraudulent or non-beneficial, issues upon which the proxy material would not bear," the Court stated: "But the causal relationship of the proxy material and the merger are questions of fact to be resolved at trial, not here. We therefore do not discuss this point further." *Id.*, at 431, 84 S.Ct. at 1559. In the present case there has been a hearing specifically directed to the causation problem. The question before the Court is whether the facts found on the basis of that hearing are sufficient in law to establish petitioners' cause of action, and we conclude that they are.

Where the misstatement or omission in a proxy statement has been shown to be "material," as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote.⁶ This requirement that the defect have a significant propensity to affect the voting process is found in the express terms of Rule 14a-9, and it adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by § 14(a).

There is no need to supplement this requirement, as did the Court of Appeals, with a requirement of proof of whether the defect actually had a decisive effect on the voting. Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. This objective test will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions.⁷

⁶ ... In this case, where the misleading aspect of the solicitation involved failure to reveal a serious conflict of interest on the part of the directors, the Court of Appeals concluded that the crucial question in determining materiality was "whether the minority shareholders were sufficiently alerted to the board's relationship to their adversary to be on their guard." An adequate disclosure of this relationship would have warned the stockholders to give more careful scrutiny to the terms of the merger than they might to one recommended by an entirely disinterested board. Thus, the failure to make such a disclosure was found to be a material defect "as a matter of law," thwarting the informed decision at which the statute aims, regardless of whether the terms of the merger were such that a reasonable stockholder would have approved the transaction after more careful analysis.

⁷ We need not decide in this case whether causation could be shown where the management controls a sufficient number of shares to approve the transaction without any votes

III

Our conclusion that petitioners have established their case by showing that proxies necessary to approval of the merger were obtained by means of a materially misleading solicitation implies nothing about the form of relief to which they may be entitled. We held in *Borak* that upon finding a violation the courts were "to be alert to provide such remedies as are necessary to make effective the congressional purpose," noting specifically that such remedies are not to be limited to prospective relief. 377 U.S., at 433, 434, 84 S.Ct. at 1560. In devising retrospective relief for violation of the proxy rules, the federal courts should consider the same factors that would govern the relief granted for any similar illegality or fraud. One important factor may be the fairness of the terms of the merger. Possible forms of relief will include setting aside the merger or granting other equitable relief, but, as the Court of Appeals below noted, nothing in the statutory policy "requires the court to unscramble a corporate transaction merely because a violation occurred." In selecting a remedy the lower courts should exercise "the sound discretion which guides the determinations of courts of equity," keeping in mind the role of equity as "the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims." *Hecht Co. v. Bowles*, 321 U.S. 321, 329-330, 64 S.Ct. 587, 591-592, 88 L.Ed. 754 (1944), quoting from *Meredith v. Winter Haven*, 320 U.S. 228, 235, 64 S.Ct. 7, 11, 88 L.Ed. 9 (1943).

...

[A] determination of what relief should be granted in *Auto-Lite's* name must hinge on whether setting aside the merger would be in the best interests of the shareholders as a whole. In short, in the context of a suit such as this one, . . . the merger should be set aside only if a court of equity concludes, from all the circumstances, that it would be equitable to do so.

Monetary relief will, of course, also be a possibility. Where the defect in the proxy solicitation relates to the specific terms of the merger, the district court might appropriately order an accounting to ensure that the shareholders receive the value that was represented as coming to them. On the other hand, where, as here, the misleading aspect of the solicitation did not relate to terms of the merger, monetary relief might be afforded to the shareholders only if the merger resulted in a reduction of the earnings or earnings potential of their holdings. In short, damages should be recoverable only to the extent that they can be shown. If commingling of the assets and operations of the merged companies

from the minority. Even in that situation, if the management finds it necessary for legal or practical reasons to solicit proxies from minority shareholders, at least one court has held that the proxy solicitation might be sufficiently related to the merger to satisfy the causation requirement, see *Laurenzano v. Einbender*, 264 F.Supp. 356 (D.C.E.D.N.Y.1966) . . . [Eds.—In *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991), however, the Supreme Court held that causation could not be established in such situations.]

makes it impossible to establish direct injury from the merger, relief might be predicated on a determination of the fairness of the terms of the merger at the time it was approved. These questions, of course, are for decision in the first instance by the District Court on remand, and our singling out of some of the possibilities is not intended to exclude others.

IV

Although the question of relief must await further proceedings in the District Court, our conclusion that petitioners have established their cause of action indicates that the Court of Appeals should have affirmed the partial summary judgment on the issue of liability. The result would have been not only that respondents, rather than petitioners, would have borne the costs of the appeal, but also, we think, that petitioners would have been entitled to an interim award of litigation expenses and reasonable attorneys' fees. We agree with the position taken by petitioners, and by the United States as amicus, that petitioners, who have established a violation of the securities laws by their corporation and its officials, should be reimbursed by the corporation or its survivor for the costs of establishing the violation.

The absence of express statutory authorization for an award of attorneys' fees in a suit under § 14(a) does not preclude such an award in cases of this type. . . .

While the general American rule is that attorneys' fees are not ordinarily recoverable as costs, both the courts and Congress have developed exceptions to this rule for situations in which overriding considerations indicate the need for such a recovery. A primary judge-created exception has been to award expenses where a plaintiff has successfully maintained a suit, usually on behalf of a class, that benefits a group of others in the same manner as himself. To allow the others to obtain full benefit from the plaintiff's efforts without contributing equally to the litigation expenses would be to enrich the others unjustly at the plaintiff's expense. This suit presents such a situation. The dissemination of misleading proxy solicitations was a "deceit practiced on the stockholders as a group," *J. I. Case Co. v. Borak*, 377 U.S., at 432, 84 S.Ct. at 1560, and the expenses of petitioners' lawsuit have been incurred for the benefit of the corporation and the other shareholders.

The fact that this suit has not yet produced, and may never produce, a monetary recovery from which the fees could be paid does not preclude an award based on this rationale. Although the earliest cases recognizing a right to reimbursement involved litigation that had produced or preserved a "common fund" for the benefit of a group, nothing in these cases indicates that the suit must actually bring money into the court as a prerequisite to the court's power to order reimbursement of expenses. "[T]he foundation for the historic practice of granting reimbursement for the costs of litigation other than the conventional taxable costs is part of the original authority of the chancellor to do equity in a particular

situation." *Sprague v. Ticonic Nat. Bank*, 307 U.S. 161, 166, 59 S.Ct. 777, 780, 83 L.Ed. 1184 (1939).

Other cases have departed further from the traditional metes and bounds of the doctrine, to permit reimbursement in cases where the litigation has conferred a substantial benefit on the members of an ascertainable class, and where the court's jurisdiction over the subject matter of the suit makes possible an award that will operate to spread the costs proportionately among them. This development has been spread pronounced, in shareholders' derivative actions, where the courts increasingly have recognized that the expenses incurred by one shareholder in the vindication of a corporate right of action can be spread among all shareholders through an award against the corporation, regardless of whether an actual money recovery has been obtained in the corporation's favor. For example, awards have been sustained in the stockholders complaining that shares of their corporation had been issued wrongfully for an inadequate consideration. A successful suit of this type, resulting in cancellation of the shares, does not bring a fund into court or add to the assets of the corporation, but it does benefit the holders of the remaining shares by enhancing their value. . . .

In many of these instances the benefit conferred is capable of expression in monetary terms, if only by estimating the increase in market value of the shares attributable to the successful litigation. However, an increasing number of lower courts have acknowledged that a corporation may receive a "substantial benefit" from a derivative suit, justifying an award of counsel fees, regardless of whether the benefit is pecuniary in nature.

"Where an action by a stockholder results in a substantial benefit to a corporation he should recover his costs and expenses. * * * [A] substantial benefit must be something more than technical in its consequence and be one that accomplishes a result which corrects or prevents an abuse which would be prejudicial to the rights and interests of the corporation or affect the enjoyment or protection of an essential right to the stockholder's interest." [*Bosch v. Meeker Cooperative Light & Power Assn.*, 101 N.W.2d 423, 425-27 (Minn. 1960).]

In many suits under § 14(a), particularly where the violation does not relate to the terms of the transaction for which proxies are solicited, it may be impossible to assign monetary value to the benefit. Nevertheless, the stress placed by Congress on the importance of fair and informed corporate suffrage leads to the conclusion that, in vindicating the statutory policy, petitioners have rendered a substantial service to the corporation and its shareholders. Whether petitioners are successful in showing a need for significant relief may be a factor in determining whether a further award should later be made. But regardless of the relief granted, private stockholders' actions of this sort "involve corporate

therapeutics,"²³ and furnish a benefit to all shareholders by providing an important means of enforcement of the proxy statute. To award attorneys' fees in such a suit to a plaintiff who has succeeded in establishing a cause of action is not to saddle the unsuccessful party with the expenses but to impose them on the class that has benefited from them and that would have had to pay them had it brought the suit.

For the foregoing reasons we conclude that the judgment of the Court of Appeals should be vacated and the case remanded to that court for further proceedings consistent with this opinion.

ANALYSIS

1. What policy goal was the Supreme Court pursuing in creating the implied private right of action under § 14(a)? Put another way, whose incentives was the Supreme Court seeking to affect?

2. In *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), the Supreme Court held that a fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *Id.* at 449. Is the omitted fact at issue in *Mills* material under this standard?

PROBLEM

Cypress Club, Inc. (CC) owns an upscale and overpriced restaurant in the foothills of Topanga Canyon, northwest of Los Angeles. Because of the glut of upscale overpriced restaurants in the area, CC is losing money. Its stock is publicly traded on the over-the-counter market. Issued for \$50 per share just five years ago, it now trades at \$3.00. An elderly financier named General Guy Sternwood owns 65 percent of the stock.

1. Suppose that CC directors propose a merger with Sternwood Investments, Inc. (SII). Through the merger, CC shareholders will receive for each CC share SII shares worth \$3.30. For the merger to take place, it must be approved by a majority of the CC shares. Suppose further, however, that the proxy materials explaining the terms of the merger do not disclose (i) that Sternwood and one Eddie Mars each own 30 percent of SII and (ii) that Mars and Sternwood are about to be indicted in Tokyo for their role in a stock-manipulation scheme on the Tokyo Stock Exchange.

You, as a CC shareholder, discover the TSE connection and sue to block the vote. Will you win? Suppose you discover the TSE connection when the indictments are issued after the vote has taken place. Can you recover damages? What would they be? Does it matter whether SII stock is publicly traded?

²³ *Murphy v. North American Light & Power Co.*, 33 F.Supp. 567, 570 (D.C.S.D.N.Y.1940).

2. Suppose that CC directors propose a merger with West Publishing Company. Through the merger, CC shareholders will receive for each CC share West shares worth \$2.70. Suppose further that the management disclosed all the details of the merger, but few CC shareholders bothered to read the proxy material. Accordingly, 95 percent of the shareholders approved the merger. You sue for damages. What result?

Seinfeld v. Bartz

2002 WL 243597 (N.D.Cal. 2002).

FACTUAL BACKGROUND

... Plaintiff is a shareholder of Defendant Cisco Systems, Inc. ("Cisco") and brings this suit as a derivative action against the company and its ten directors. At issue in this case is a 1999 amendment to Cisco's Automatic Option Grant Program for outside directors. The amendment, which was approved by shareholder vote at the November 1999 annual meeting, raised the number of stock options granted to outside directors upon joining the board from 20,000 shares to 30,000 shares.* Additionally, the amendment raised the number of options granted annually to each continuing outside director from 10,000 shares to 15,000 shares.

Plaintiff alleges that Defendants acted negligently in preparing their statement to solicit proxies to vote in favor of the amendment. The disputed proxy statement states that Cisco paid each outside director, except for Defendant Sarin, a \$32,000 annual retainer fee for fiscal year 1999, and that it paid Defendant Sarin a \$40,000 retainer fee to include board service commencing in September 1998. In addition, the statement represents that each director would receive periodic option grants under the Automatic Option Grant Program and was eligible to participate in the Discretionary Option Grant Program. The statement goes on to explain the number of options granted to each director, as well as the options' exercise prices and vesting requirements.

Plaintiff alleges that Defendants violated SEC proxy rules by failing to include the value of the option grants based on the theoretical Black-

* [Eds.—Options come in two basic forms: (1) call options, which give their holder the right to buy from the issuer of the option an underlying asset, such as the common stock of a company, at a set price (called the strike price or the exercise price), usually with an expiration date; and (2) put options, which give their holder the right to sell to the issuer of the option an underlying asset, such as the common stock of a company, at a set price, usually with an expiration date. Options on corporate stock may be issued and traded by individuals (so-called market options) or, as in this case, call options may be issued by corporations to their employees as compensation (so-called compensatory stock options). Options issued to employees have become an important part of executive compensation and, at many firms, are also used to compensate nonexecutive employees.]

Scholes option pricing model.* According to Plaintiff's Black-Scholes calculations, the value of the options granted to each of the continuing outside directors in 1998 was \$369,500 on November 12, 1998 (the date of the grant) and \$1,020,600 on September 27, 1999 (the date of the proxy statement). Plaintiff asserts that Cisco uses Black-Scholes to prepare its annual financial statements,** and that it therefore would have been easy for Defendants to include the Black-Scholes valuations in the proxy statement. More significantly, Plaintiff alleges that Defendants' statement of a \$32,000 annual retainer fee plus stock options materially misrepresents the compensation of each outside director. Plaintiff contends that, using Black-Scholes, each director received compensation valued at well over \$32,000.

In addition, Plaintiff alleges that the following sentence contained in the proxy statement is materially false and misleading: "Unless the market price of the Common Stock appreciates over the option term, no value will be realized from the option grants made to the executive officers." Plaintiff asserts that this statement is false because the grant of stock options results in the immediate realization of value, which is best determined using Black-Scholes. . . .

DISCUSSION

Plaintiff alleges that Defendants negligently violated Section 14(a) of the Securities Exchange Act of 1934 and Rule 14a-9 of the Securities and Exchange Commission ("SEC"). Section 14(a) makes it unlawful to solicit proxies in violation of SEC rules. 15 U.S.C. § 78n(a) (2002). SEC Rule 14a-9 prohibits solicitation of a proxy by a statement containing either (1) a false or misleading declaration of material fact or (2) an

* [Eds.—The value of an option depends, among other things, on the value of the underlying asset at the time the option is exercised. Suppose, for example, that you hold a call option giving you the right to buy one share of Acme Corporation stock at a strike price of \$1. If the value of Acme's stock exceeds \$1, at which point it is said to be "in the money," the option has value because you can buy the share for \$1 and then immediately sell it at the higher price. At the time the option was issued, however, the issuer has no way of knowing what the stock price will be when the option is exercised. Options therefore are notoriously difficult to value when issued. The so-called Black-Scholes formula was developed by economists Fischer Black and Myron Scholes to value options. Although the formula is complex, and its derivation bewilderingly mathematical, it has become the most widely accepted method for valuing options. In brief, the Black-Scholes formula considers five factors in valuing an option: (1) the current value of the underlying asset; (2) the exercise price; (3) the current discount rate (i.e., the rate at which sums to be received in the future are discounted to present value); (4) the price volatility of the underlying asset; and (5) the amount of time remaining until expiration of the option.]

** [Eds.—Employee compensation is an expense which, under generally accepted accounting principles, must be deducted from revenue to determine a firm's income. Before the corporate accounting scandals of 2002, however, corporations commonly refused to recognize the value of stock options granted as compensation to employees as an expense. In footnotes to their financial statements, public corporations are obliged to disclose the number and estimated value of stock options issued as compensation. Presumably Cisco used the Black-Scholes formula to estimate the value of the options for this purpose. Under prevailing accounting standards, however, corporations had an option as to the income statement treatment of stock options. The corporation could treat stock options as an expense, again using the Black-Scholes formula (or some other plausible method) to estimate the size of that expense, but was not obliged to do so. Most chose not to do so. Since 2006, an SEC rule has required that options be treated as expenses in the financial reports of registered companies.]

omission of material fact that makes any portion of the statement false or misleading. . . . An omitted fact is "material" if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). A plaintiff does not have to demonstrate that disclosure of the fact in question would have caused a reasonable shareholder to change his or her vote. *Id.* Instead, it is sufficient to establish a substantial likelihood that, "under all of the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder." *Id.* In other words, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.*

Failure to Include Black-Scholes Valuations in the Proxy Statement

Here, Plaintiff asserts that the Black-Scholes valuations of the option grants to the outside directors are omitted material facts. As Defendants point out, however, four courts that have considered Plaintiff's argument have rejected it at the pleading stage. See *Resnik v. Swartz*, No. 00 Civ. 5355(LMM), 2001 WL 15671 (S.D.N.Y. Jan. 8, 2001); *In re 3Com Corp. Shareholders Litig.*, No. C.A. 16721, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999); *Cohen v. Calloway*, 667 N.Y.S.2d 249 (N.Y.App.Div.1998); *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch.1997). The courts in all four of these cases held that Black-Scholes valuations are not material as a matter of law. To the parties' and the Court's knowledge, no court has ever held to the contrary. . . .

While not controlling precedent, the above cases are highly persuasive because of the factual similarities they share with the instant case.

Plaintiff attempts to distinguish the three state-court cases—but, notably, does not even mention *Resnik* in his written opposition—on grounds that they were applying state, rather than federal, law. Plaintiff correctly points out that the plaintiffs in the Delaware cases alleged breach of the state-law-based duty of candor, and not the federally defined Rule 14a-9. However, the New York and Delaware courts applied the same "materiality" standard that this Court is bound to apply under the U.S. Supreme Court's decision in *TSC Industries*. Thus, the fact that the state cases addressed state-law causes of action does not require this Court to reject the analysis in those cases.

Plaintiff next argues that a Ninth Circuit case, *Custom Chrome, Inc. v. Commissioner of Internal Revenue*, 217 F.3d 1117 (9th Cir.2000), requires this Court to break new ground and reject the decisions made by the four courts discussed above. In *Custom Chrome*, the Ninth Circuit noted in a footnote that Black-Scholes was a reliable method of determining the value of the options at issue in that case. *Id.* at 1124 n. 10. However, as Defendants correctly point out, the court explicitly distinguished the options at issue—which were issued as part of a loan

transaction—from options granted for services rendered.* Id. at 1122. In this case, Defendants received options for the services they rendered as Cisco's directors, and *Custom Chrome* is therefore distinguishable.

Custom Chrome is further distinguishable because tax regulations require that the options in that case be valued at the time of grant. Id. at 1122. Here, by contrast, nothing requires Defendants to calculate the value of the options at time of grant. Plaintiff argues that SEC regulations require Black-Scholes calculations, but he points to no specific regulation that requires them. . . .

Based on the persuasive case law presented by Defendants, and the lack of convincing rebuttal by Plaintiff, this Court rules that, as a matter of law, Black-Scholes valuations are not material for purposes of Rule 14a-9 analysis. . . .

ANALYSIS

1. In the fifth paragraph of the opinion, the court quotes this sentence from Cisco's proxy statement:

Unless the market price of the Common Stock appreciates over the option term, no value will be realized from the option grants made to the executive officers.

Is this statement accurate?

2. Suppose Helen owns the house she lives in free and clear and that its market value is \$200,000. Now suppose Helen grants to Owen the option to buy the house any time within the next five years for \$200,000. Do you suppose Helen could still sell the house for \$200,000 to someone else? Do you suppose that on the date of receipt of the option Owen would feel any richer, even though the market value of the house had not risen? Suppose that Helen is a lawyer and that she granted the option to Owen in return for Owen's services to her as her secretary for the past year. If Helen wants to be realistic about her income for the year, should she ignore the option grant?

3. Do you agree with the court that the omission of the Black-Scholes valuation was not material as a matter of law?

4. Suppose the options had been treated as compensation at the time of grant, so the recipients would have income and Cisco would have a deduction in computing its income. Now suppose that the duration of the options when issued was five years and that a year later the market price of the stock had fallen and, consequently, the value of the options

* [Eds.—*Custom Chrome, Inc. v. Commissioner of Internal Revenue*, 217 F.3d 1117 (9th Cir.2000), was a tax case. The taxpayer had borrowed money from a bank and, as part of the transaction, had issued warrants (options issued by a corporation on its own stock) to the bank. The court determined that the value of the options was, in effect, a reduction in the amount received by the borrower as loan proceeds. This resulted in "original issue discount" (discount from the face amount of the loan), which had important tax consequences. In order to determine that amount of the original issue discount (OID), it was necessary to value the warrants, and the court identified the Black-Scholes formula as the proper method for doing so.]

had fallen by an even greater percentage. How should this reality be reflected in Cisco's annual report of its income?

D. SHAREHOLDER PROPOSALS

Trinity Wall Street v. Wal-Mart Stores, Inc.

792 F.3d 323 (3rd Cir. 2015).

I. INTRODUCTION

...

Appellant Wal-Mart Stores, Inc., the world's largest retailer, and one of its shareholders, Appellee Trinity Wall Street—an Episcopal parish headquartered in New York City that owns Wal-Mart stock—are locked in a heated dispute. It stems from Wal-Mart's rejection of Trinity's request to include its shareholder proposal in Wal-Mart's proxy materials for shareholder consideration.

Trinity's proposal, while linked to Wal-Mart's sale of high-capacity firearms (guns that can accept more than ten rounds of ammunition) at about one-third of its 3,000 stores, is nonetheless broad. It asks Wal-Mart's Board of Directors to develop and implement standards for management to use in deciding whether to sell a product that (1) "especially endangers public safety"; (2) "has the substantial potential to impair the reputation of Wal-Mart"; and/or (3) "would reasonably be considered by many offensive to the family and community values integral to the Company's promotion of its brand." Standing in Trinity's way, among other things, is a rule of the Securities and Exchange Commission ("SEC" or "Commission"), known as the "ordinary business" exclusion ("Rule 14a-8(i)(7)"). As its name suggests, the rule lets a company omit a shareholder proposal from its proxy materials if the proposal relates to its ordinary business operations.

Wal-Mart obtained what is known as a "no-action letter" from the staff of the SEC's Division of Corporate Finance (the "Corp. Fin. staff" or "staff"), thus signaling that there would be no recommendation of an enforcement action against the company if it omitted the proposal from its proxy materials. Trinity thereafter filed suit in federal court, seeking to enjoin Wal-Mart's exclusion of the proposal. The . . . District Court . . . handed the church a victory on the merits some seven months later by holding that, because the proposal concerned the company's Board (rather than its management) and focused principally on governance (rather than how Wal-Mart decides what to sell), it was outside Wal-Mart's ordinary business operations. Wal-Mart appeals, seeking a ruling that it could exclude Trinity's proposal from its 2015 proxy materials and did not err in excluding the proposal from its 2014 proxy materials.

Stripped to its essence, Trinity's proposal—although styled as promoting improved governance—goes to the heart of Wal-Mart's

SECTION 1

business: what it sells on its shelves. For the reasons that follow, we hold that it is excludable under Rule 14a-8(i)(7) and reverse the ruling of the District Court.

II. FACTS & PROCEDURAL HISTORY

...
A. Trinity Objects to Wal-Mart's Sale of Assault Rifles.

... Trinity [is] one of the wealthiest religious institutions in the United States, with a balance sheet of over \$800 million in assets and real estate valued at approximately \$3 billion. Its strong financial footing, according to Trinity, empowers it to "pursue a mission of good works beyond the reach of other religious institutions." Part of that mission is to reduce violence in society.

Alarmed by the spate of mass murders in America, in particular the shooting at Sandy Hook Elementary School in December 2012, Trinity resolved to use its investment portfolio to address the ease of access to rifles equipped with high-capacity magazines (the weapon of choice of the Sandy Hook shooter and other mass murderers). Its principal focus was Wal-Mart.

During its review of Wal-Mart's merchandising practices, Trinity discovered what it perceived as a major inconsistency. Despite the retailer's stated mission to "make a difference on the big issues that matter to us all," it continued in some states to sell the Bushmaster AR-15 (a model of assault rifle). Trinity also perceived Wal-Mart as taking an unprincipled approach in deciding which products to sell. For example, despite its position on the AR-15, Wal-Mart does not sell adult-rated movie titles (i.e., those rated NC-17) or similarly rated video or computer games. Nor does it sell to children under 17 "R" rated movies or "Mature" rated video games." Wal-Mart also doesn't sell "music bearing a 'Parental Advisory Label'" because of concerns about the music containing "strong language or depictions of violence, sex, or substance abuse." And apparently due to safety concerns, it has stopped selling (1) handguns in the United States; (2) high-capacity magazines separate from a gun; and (3) guns through its website. Trinity attributes these perceived inconsistencies to the "lack of written policies and Board oversight concerning its approach to products that could have momentous consequences for both society and corporate reputation and brand value[.]"

B. Trinity's Shareholder Proposal.

Trinity pressed Wal-Mart to explain its continued sale of the Bushmaster AR-15. Wal-Mart's response was as follows:

There are many viewpoints on this topic and many in our country remain engaged in the conversations about the sale and regulation of certain firearms. In areas of the country where we sell firearms, we have a long standing commitment to do so

safely and responsibly. Over the years, we've been very purposeful about finding the right balance between serving hunters and sportsmen and ensuring that we sell firearms responsibly. Wal-Mart's merchandising decisions are based on customer demand and we recognize that most hunters and sportsmen use firearms responsibly and wish to continue to do so. . . .

While there are some like you, Rev. Cooper, who ask us to stop selling firearms, there are many customers who ask us to continue to sell these products in our stores.

Unmoved, Trinity drafted a shareholder proposal aimed at filling the governance gap it perceived. The proposal, which is the subject of this appeal, provides:

Resolved:

Stockholders request that the Board amend the Compensation, Nominating and Governance Committee charter . . . as follows:

"27. Providing oversight concerning [and the public reporting of] the formulation and implementation of . . . policies and standards that determine whether or not the Company should sell a product that:

- 1) especially endangers public safety and well-being;
- 2) has the substantial potential to impair the reputation of the Company; and/or
- 3) would reasonably be considered by many offensive to the family and community values integral to the Company's promotion of its brand."

The narrative part of the proposal makes clear it is intended to cover Wal-Mart's sale of certain firearms. It provides that the oversight and reporting is intended to cover policies and standards that would be applicable to determining whether or not the company should sell guns equipped with magazines holding more than ten rounds of ammunition ("high capacity magazines") and to balancing the benefits of selling such guns against the risks that these sales pose to the public and to the Company's reputation and brand value.

C. Wal-Mart Seeks a No-Action Letter from the SEC.⁴

On January 30, 2014, Wal-Mart notified Trinity and the Corp. Fin. staff of its belief that it could exclude the proposal from its 2014 proxy materials under Rule 14a-8(i)(7). Trinity predictably disagreed, stating

⁴ In the words of the SEC, a "no-action letter is one in which an authorized staff official indicates that the staff will not recommend any enforcement action to the Commission if the proposed transaction described in the incoming correspondence is consummated." Procedures Utilized by the Division of Corporate Finance for Rendering Informal Advice, Release No. 6,253, 1980 WL 25632, at *1 n. 2 (Oct. 28, 1980).

that its proposal didn't "meddl[e] in ordinary course decision-making" but focused on "big picture oversight and supervision that is the responsibility of the Board." In support of that assertion, Trinity offered three reasons why its proposal was not excludable:

1. [it] addresses corporate governance through Board oversight of important merchandising policies and is substantially removed from particularized decision-making in the ordinary course of business;

2. [it] concerns the Company's standards for avoiding community harm while fostering public safety and corporate ethics and does not relate exclusively to any individual product; and

3. [it] raises substantial issues of public policy, namely a concern for the safety and welfare of the communities served by the Company's stores.

Trinity also touted the proposal as: not dictating "the specifics of how that Board oversight will operate or how best to report publicly on the policies being followed by the Company and their implementation," not seeking to "determine what products should or should not be sold by the Company," allowing policy development "not by shareholders, but by management, using its knowledge and discretion," and addressing "the ethical responsibility of the Company to take account of public safety and well-being, and the related risks of damage to the Company's reputation and brand."

On March 20, 2014, the Commission's Corp. Fin. staff issued a "no-action" letter siding with Wal-Mart . . . because "[p]roposals concerning the sale of particular products and services are generally excludable under [the rule]." Wal-Mart Stores, Inc., SEC No-Action Letter, 2014 WL 409085, at *1 (Mar. 20, 2014). . . .

Because no-action letters are not binding—they reflect only informal views of the staff and are not decisions on the merits—Trinity's proposal still had life.

D. Trinity Takes its Fight to Federal Court: Round One.

On April 1, 2014, and just 17 days before Wal-Mart's proxy materials were due at the printer, Trinity filed a declaratory judgment action against Wal-Mart in the District of Delaware. It sought a declaration that "Wal-Mart's decision to omit the proposal from [its] 2014 Proxy Materials violates Section 14(a) of the 1934 Act and Rule 14a-8." . . .

E. Round Two.

. . . The District Court . . . concluded that, although the proposal "could (and almost certainly would) shape what products are sold by Wal-Mart," it is "best viewed as dealing with matters that are not related to Wal-Mart's ordinary business operations." Thus Rule 14(a)-8 could not block its inclusion in Wal-Mart's proxy materials. The Court fastened its

holding to the view that the proposal wasn't a directive to management but to the Board to "oversee the development and effectuation of a Wal-Mart policy." In this way, "[a]ny direct impact of adoption of a Wal-Mart proposal would be felt at the Board level; it would then be for [it] to determine what, if any, policy should be formulated and implemented." Stated differently, the day-to-day responsibility for implementing whatever policies the Board develops was outside the scope of the proposal.

In the alternative, the Court held that even if the proposal does tread on the core of Wal-Mart's business—the products it sells—it "nonetheless 'focuses on sufficiently significant social policy issues' " that "transcend[] the day-to-day business matters" of the company, making the proposal "appropriate for a shareholder vote." Among the policy issues the District Court noted are "the social and community effects of sales of high capacity firearms at the world's largest retailer and the impact this could have on Wal-Mart's reputation, particularly if such a product sold at Wal-Mart is misused and people are injured or killed as a result."

III. REGULATORY BACKGROUND

...

The SEC's "proxy rules are concerned with assuring full disclosure to investors of matters likely to be considered at shareholder meetings." [3 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* § 10.2[1] (6th ed. 2009)]. To that end, the SEC adopted . . . Rule 14a-8 "to catalyze what many hoped would be a functional 'corporate democracy.'" Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 Ala. L.Rev. 879, 879 (1994). The rule mandates subsidized shareholder access to a company's proxy materials, requiring "reporting companies . . . to print and mail with management's proxy statement, and to place on management's proxy ballot, any 'proper' proposal submitted by a qualifying shareholder." *Id.* at 886 The idea was to provide shareholders a way to "bring before their fellow stockholders matters of [shareholder concern]" that are "proper subjects for stockholders' action under the laws of the state under which [the Company] was organized," 1982 Proposing Release, 1982 WL 600869, at *3, and to "have proxies with respect to such proposals solicited at little or no expense to the security holder," *id.* at *2.

...

Though the Rule 14a-8 option is financially advantageous, it does not "create an open forum for shareholder communication." Palmiter at 886. Rule 14a-8 restricts the company-subsidy to "shareholders who offer 'proper' proposals." *Id.* at 879 A "proper" proposal is one that doesn't fit within one of Rule 14a-8's exclusionary grounds—which are both substantive and procedural.

The procedural exclusions of the rule "protect the solicitation process without regard to a proposal's content[.]" Palmiter at 886. For example,

the proponent "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 meeting for at least one year by the date [it] submit[s] the proposal." [Rule] 14a-8(b)(1). It can "submit no more than one proposal to a company for a particular shareholders' meeting." [Rule] 14a-8(b)(2)(i). And the "proposal, including any accompanying supporting statement, may not exceed 500 words." [Rule] 14a-8(d).

The rule's substantive exclusions, by contrast, are "the most frequently used (and most litigated)." Palmiter at 890. They include (1) the "proper subjects" exclusion, which exists "[i]f the proposal is not a proper subject for action by shareholders under the law of the jurisdiction of the company's organization," [Rule] 14a-8(i)(1); (2) the "false or misleading" exclusion, which allows companies to bar proposals that are too vague, [Rule] 14a-8(i)(3); (3) the "substantially related" exclusion, which says that a proposal is excludable if it "relates to operations which account for less than 5 percent of the company's total assets [and net earnings and gross sales] at the end of its most recent fiscal year . . . , and is not otherwise significantly related to the company's business" [Rule] 14a-8(i)(5); and, most relevant for purposes of this opinion, (4) the "ordinary business" exclusion, which disallows a proposal that "deals with a matter relating to the company's ordinary business operations," [Rule] 14a-8(i)(7). See Palmiter 890.

If a company wants to invoke one of these grounds to exclude a proposal, the process is as follows. First, it must notify the shareholder in writing of the problem with the proposal within 14 days of receiving it and inform the shareholder that it has 14 days to respond. If the company finds the shareholder's response unpersuasive and still wants to exclude the proposal, it then must file with the Corp. Fin. staff the reasons why it believes the proposal is excludable no later than 80 days before the company files its proxy materials with the SEC. In this letter, the company may also ask the staff for a no-action letter to support the exclusion of a proposal. If the shareholder wants to respond, it can file a submission noting why exclusion would be improper.

The staff will respond in one of two ways: (1) with a no-action letter, specifying that the company may omit the shareholder proposal under the exclusion(s) it relied on; or (2) that it is "unable to concur" with the company. A shareholder dissatisfied with the staff's response can, as Trinity did here, pursue its rights against the company in federal court.

...

The ordinary business exclusion has been called the "most perplexing" of all the 14a-8 bars. See Daniel E. Lazaroff, Promoting Corporate Democracy and Social Responsibility: The Need to Reform the Federal Proxy Rules on Shareholder Proposals, 50 Rutgers L.Rev. 33, 94 (1997). This stems from the opaque term "ordinary business," which is neither self-defining nor consistent in its meaning across different

corporate contexts. Neither the courts nor Congress have offered a corrective. . . .

[In 1976 the SEC issued guidance explaining that] the exclusion should be "interpreted somewhat more flexibly than in the past" and reaffirmed that the term "ordinary business operations" has been wrongly interpreted to "include certain matters which have significant policy, economic or other implications inherent in them. For instance, a proposal that a utility company not construct a nuclear power plant has in the past been [wrongly] considered" to be excludable. [Adoption of Amendments Relating to Proposals by Security Holders, Release No. 12,999, 1976 WL 160347 (Nov. 22, 1976) ("1976 Adopting Release").] Therefore, "proposals of that nature, as well as others that have major implications, will in the future be considered beyond the realm of an issuer's ordinary business operations." *Id.*

...

IV. ANALYSIS

...

A. Trinity's Proposal Relates to Wal-Mart's Ordinary Business Operations.

We employ a two-part analysis to determine whether Trinity's proposal "deals with a matter relating to the company's ordinary business operations [.]". Under the first step, we discern the "subject matter" of the proposal. See 1983 Adopting Release, 1983 WL 33272, at *7. Under the second, we ask whether that subject matter relates to Wal-Mart's ordinary business operations. If the answer to the second question is yes, Wal-Mart must still convince us that Trinity's proposal does not raise a significant policy issue that transcends the nuts and bolts of the retailer's business.

1. What is the subject matter of Trinity's proposal?

Beginning with the first step, we are mindful of the Commission's consistent nod to substance over form and its distaste for clever drafting. [It] matters little how a shareholder styles its proposal; the emphasis should always be on its substance. . . . Thus, even though Trinity's proposal asks for the development of a specific merchandising policy—and not a review, report or examination—we still ask whether the subject matter of the action it calls for is a matter of ordinary business.

Applying that principle, we part ways with the District Court. We perceive it put undue weight on the distinction between a directive to management and a request for Board action. In the District Court's view, if the proposal had directed management to arrange its product assortment in a certain way, it would have been excludable. But because it merely asked the "Board [to] oversee the development and effectuation of a Wal-Mart policy," it was not. Trinity, 75 F.Supp.3d at 630 The concern with this line of reasoning is that [in 1976] the SEC . . . rejected

the proposed bright line whereby shareholder proposals involving "matters that would be handled by management personnel without referral to the board . . . generally would be excludable," but those involving "matters that would require action by the board would not be." 1976 Proposing Release, 1976 WL 160410, at *8. Thus, though the District Court's rationale and holding are not implausible, we do not adopt them.

Distancing itself from the District Court's formal approach, Trinity argues that the subject matter of its proposal is the improvement of "corporate governance over strategic matters of community responsibility, reputation for good corporate citizenship, and brand reputation, none of which can be considered ordinary business," and the focus is on the "shortcomings in Wal-Mart's corporate governance and oversight over policy matters." We cannot agree. As the National Association of Manufacturers points out, Trinity's contention, like the District Court's analysis, relies "on how [the proposal] is framed and to whom, rather than [its] substance." Brief of amicus curiae Nat'l Assoc. of Mfrs. 15. Contrary to what Trinity would have us believe, the immediate consequence of the adoption of a proposal—here the improvement of corporate governance through the formulation and implementation of a merchandising policy—is not its subject matter. If it were, then, analogizing to the review context, the subject matter of a review would be the review itself rather than the information sought by it. For example, under Trinity's position, the subject matter of a proposal that calls for a report on how a restaurant chain's menu promotes sound dietary habits would be corporate governance as opposed to important matters involving the promotion of public health. . . . The subject matter of the proposal is instead its ultimate consequence—here a potential change in the way Wal-Mart decides which products to sell. . . .

. . . For us, the subject matter of Trinity's proposal is how Wal-Mart approaches merchandising decisions involving products that (1) especially endanger public-safety and well-being, (2) have the potential to impair the reputation of the Company, and/or (3) would reasonably be considered by many offensive to the family and community values integral to the company's promotion of the brand. A contrary holding—that the proposal's subject matter is "improved corporate governance"—would allow drafters to evade Rule 14a-8(i)(7)'s reach by styling their proposals as requesting board oversight or review. We decline to go in that direction.

2. Does Wal-Mart's approach to whether it sells particular products relate to its ordinary business operations?

Reaching the second step of the analysis, we ask whether the subject matter of Trinity's proposal relates to day-to-day matters of Wal-Mart's business. Wal-Mart says the answer is yes because, even though the proposal doesn't demand any specific changes to the make-up of its product offerings . . . it "seeks to have a [B]oard committee address

policies that could (and almost certainly would) shape what products are sold by Wal-Mart." Reply Br. 9 That is, Trinity's proposal is just a sidestep from "a shareholder referendum on how [Wal-Mart] selects its inventory." Brief of amicus curiae the Nat'l Assoc. of Mfrs. at 11. And thus its subject matter strikes at the core of Wal-Mart's business.

We agree. A retailer's approach to its product offerings is the bread and butter of its business. As amicus the National Association of Manufacturers notes, "Product selection is a complicated task influenced by economic trends, data analytics, demographics, customer preferences, supply chain flexibility, shipping costs and lead-times, and a host of other factors best left to companies' management and boards of directors." *Id.* at 12 Though a retailer's merchandising approach is not beyond shareholder comprehension, the particulars of that approach involve operational judgments that are ordinary-course matters.

Moreover, that the proposal doesn't direct management to stop selling a particular product or prescribe a matrix to follow is, we think, a straw man. A proposal need only relate to a company's ordinary business to be excludable. It need not dictate any particular outcome. To make the point even clearer, suppose that Trinity's proposal had merely asked Wal-Mart's Board to reconsider whether to continue selling a given product. Though the request doesn't dictate a particular outcome, we have no doubt it would be excludable . . . , as the action sought relates to Wal-Mart's ordinary business operations. This is so even though it doesn't suggest any changes. The same is true here. In short, so long as the subject matter of the proposal relates—that is, bears on—a company's ordinary business operations, the proposal is excludable unless some other exception to the exclusion applies.

B. Trinity's Proposal Does Not Focus on a Significant Policy Issue that Transcends Wal-Mart's Day-to-Day Business Operations.

As discussed above, there is a significant social policy exception to the default rule of excludability for proposals that relate to a company's ordinary business operations. . . .

The difficulty in this case is divining the line between proposals that focus on sufficiently significant social policy issues that transcend a company's ordinary business (not excludable) from those that don't (excludable). . . .

We think the inquiry is again best split into two steps. The first is whether the proposal focuses on a significant policy (be it social or, as noted below, corporate). If it doesn't, the proposal fails to fit within the social-policy exception to Rule 14a-8(i)(7)'s exclusion. If it does, we reach the second step and ask whether the significant policy issue transcends the company's ordinary business operations.

1. Does Trinity's proposal raise a significant social policy issue?

We first turn to whether Trinity's proposal focuses on a "sufficiently significant" policy issue like "significant [employment] discrimination."

1998 Adopting Release, 1998 WL 254809, at *4. . . . [It] is hard to counter that Trinity's proposal doesn't touch the bases of what are significant concerns in our society and corporations in that society. Thus we deem that its proposal raises a matter of sufficiently significant policy.

...

2. Even if Trinity's proposal raises a significant policy issue, does that issue transcend Wal-Mart's ordinary business operations?

To repeat, . . . a shareholder must do more than focus its proposal on a significant policy issue; the subject matter of its proposal must "transcend" the company's ordinary business. . . . Thus, . . . we think the transcendence requirement plays a pivotal role in the social-policy exception calculus. Without it shareholders would be free to submit "proposals dealing with ordinary business matters yet cabined in social policy concern." *Apache Corp. v. New York City Emps.' Ret. Sys.*, 621 F.Supp.2d 444, 451 n. 7 (S.D.Tex.2008)

For major retailers of myriad products, a policy issue is rarely transcendent if it treads on the meat of management's responsibility: crafting a product mix that satisfies consumer demand. This explains why the Commission's staff, almost as a matter of course, allows retailers to exclude proposals that "concern[] the sale of particular products and services." *Rite Aid Corp.*, SEC No-Action Letter, 2015 WL 364996, at *1 (Mar. 24, 2015). On the other hand, if a significant policy issue disengages from the core of a retailer's business (deciding whether to sell certain goods that customers want), it is more likely to transcend its daily business dealings.

To illustrate the distinction, a proposal that asks a supermarket chain to evaluate its sale of sugary sodas because of the effect on childhood obesity should be excludable because, although the proposal raises a significant social policy issue, the request is too entwined with the fundamentals of the daily activities of a supermarket running its business: deciding which food products will occupy its shelves. So too would a proposal that, out of concern for animal welfare, aims to limit which food items a grocer sells. . . .

By contrast, a proposal raising the impropriety of a supermarket's discriminatory hiring or compensation practices generally is not excludable because, even though human resources management is a core business function, it is disengaged from the essence of a supermarket's business. The same goes for proposals asking for information on the environmental effect of constructing stores near environmentally sensitive sites.

With those principles in mind, we turn to Trinity's proposal. Trinity says it focuses on "both corporate policy and social policy"—specifically, the "transcendent policy issue of under what policies and standards and with what Board oversight Wal-Mart handles [] merchandising decisions" for products that are "especially dangerous to [the company's]

reputation, brand value, or the community." *Trinity Br. 44* "In an age of mass shootings, increased violence, and concerns about product safety," *Trinity* argues, "the [p]roposal goes to the heart of Wal-Mart's impact on and approach to social welfare as well as the risks such impact and approach may have to Wal-Mart's reputation and brand image and its community." *Id.* at 43.

But is how a retailer weighs safety in deciding which products to sell too enmeshed with its day-to-day business? We think it is in this instance. As we noted before, the essence of a retailer's business is deciding what products to put on its shelves—decisions made daily that involve a careful balancing of financial, marketing, reputational, competitive and other factors. The emphasis management places on safety to the consumer or the community is fundamental to its role in managing the company in the best interests of its shareholders and cannot, "as a practical matter, be subject to direct shareholder oversight." 1998 Adopting Release, 1998 WL 254809, at *4. Although shareholders perform a valuable service by creating awareness of social issues, they are not well-positioned to opine on basic business choices made by management.

It is thus not surprising that the Corp. Fin. staff consistently allows retailers to omit proposals that address their product menu. For example, it has indicated that a proposal trying to stop a retailer from selling or promoting products that connote negative stereotypes is excludable. It has done the same for proposals aiming to restrict a retailer's promotion of products that pose a threat to public health, as well as those proposals targeting a retailer's approach to product safety.

For further support of the view that a policy issue does not transcend a company's ordinary business operations where it targets day-to-day decision-making, we look to the difference in treatment of stop-selling proposals sent to retailers and those sent to pure-play manufacturers [that is, undiversified]. A policy matter relating to a product is far more likely to transcend a company's ordinary business operations when the product is that of a manufacturer with a narrow line. Here the staff often will decline a no-action request.

But the outcome changes where those same policy proposals are directed at retailers who sell thousands of products.

The reason for the difference, in our view, is that a manufacturer with a very narrow product focus—like a tobacco or gun manufacturer—exists principally to sell the product it manufactures. Its daily business deliberations do not involve whether to continue to sell the product to which it owes its reason for being. As such, a stop-selling proposal generally isn't excludable because it relates to the seller's very existence. Quite the contrary for retailers. They typically deal with thousands of products amid many options for each, precisely the sort of business decisions a retailer makes many times daily. Thus, and in contrast to the manufacturing context, a stop-selling proposal implicates a retailer's

ordinary business operations and is in turn excludable. Although Trinity's proposal is not strictly a stop-selling proposal, it still targets the same basic business decision: how to weigh safety risks in the merchandising calculus.

Trinity's claim that its proposal raises a "significant" and "transcendent" corporate policy is likewise insufficient to fit that proposal within the social-policy exception to exclusion. See Trinity Br. 47. The relevant question to us is whether Wal-Mart's consideration of the risk that certain products pose to its "economic success" and "reputation for good corporate citizenship" is enmeshed with the way it runs its business and the retailer-consumer interaction. We think the answer is yes. Decisions relating to what products Wal-Mart sells in its rural locations versus its urban sites will vary considerably, and these are quintessentially calls made by management. Wal-Mart serves different Americas with different values. Its customers in rural America want different products than its customers in cities, and that management decides how to deal with these differing desires is not an issue typical for its Board of Directors. Indeed, catering to "small-town America" is how Wal-Mart built its business. And whether to put emphasis on brand integrity and brand protection, or none at all, is naturally a decision shareholders as well as directors entrust management to make in the exercise of their experience and business judgment.

...

We thus hold that, even if Trinity's proposal raises sufficiently significant social and corporate policy issues, those policies do not transcend the ordinary business operations of Wal-Mart. For a policy issue here to transcend Wal-Mart's business operations, it must target something more than the choosing of one among tens of thousands of products it sells. Trinity's proposal fails that test and is properly excludable under Rule 14a-8(i)(7).

ANALYSIS

1. In order to discern the true subject matter of a proposal, one must determine the "ultimate consequence" of a proposal. How does one do so?
2. The court explained that: "In short, so long as the subject matter of the proposal relates—that is, bears on—a company's ordinary business operations, the proposal is excludable unless some other exception to the exclusion applies." How does one determine if the proposal relates to "a company's ordinary business operations"?
3. Should proposals bearing on strategic decisions—such as a proposal that the company sell all or substantially all of the corporation's assets—be excludable under Rule 14a-8(i)(7)?
4. The court stated that "it is hard to counter that Trinity's proposal doesn't touch the bases of what are significant concerns in our

society and corporations in that society." But does the court provide any helpful advice as to how to decide harder cases? What metric should courts use to determine a proposal's significance? How does one determine whether the proposal's significance is sufficient?

5. In order to be sufficiently significant, a proposal must transcend "day-to-day business matters." Transcend is undefined in the opinion. Instead, the court contrasts a proposal that is not excludable because it transcends the company's ordinary business with one that is excludable because it is "enmeshed with the way it runs its business and the retailer-consumer interaction." Unfortunately, the court also failed to define "enmeshed." The mental images invoked by the dictionary definition—"[t]o mesh; to tangle or interweave in such a manner as not to be easily separated, particularly in a mesh or net like manner—are singularly unhelpful. The same is true of the dictionary definition of transcend, which is "to pass beyond the limits of something." Once again, the question thus is how one determines when a proposal transcends "day-to-day business matters."

6. If selling sugary sodas is ordinary business, should not making them be so as well?

7. Is it true that Trinity's proposal "targets the same basic business decision" as would a "stop selling" proposal?

8. Is it in fact the case that "shareholders perform a valuable service by creating awareness of social issues"? If so, what is that service and to whom is it rendered? Do the costs of providing this service outweigh the benefits it produces?

9. If "it is neither fair nor reasonable to expect securities experts [like the Commission and its staff] to deduce the prevailing wind on public policy issues that have yet to be addressed by Congress in any decisive fashion," does that not suggest that a proposal's social significance ought to be irrelevant in deciding whether it must be included on the company's proxy statement?

Lovenheim v. Iroquois Brands, Ltd.

618 F.Supp. 554 (D.D.C.1985).

I. BACKGROUND

Plaintiff Peter C. Lovenheim, owner of two hundred shares of common stock in Iroquois Brands, Ltd. (hereinafter "Iroquois/Delaware"), seeks to bar Iroquois/Delaware from excluding from the proxy materials being sent to all shareholders in preparation for an upcoming shareholder meeting information concerning a proposed resolution he intends to offer at the meeting. Mr. Lovenheim's proposed resolution relates to the procedure used to force-feed geese for production of pâté de

foie gras in France,² a type of pâté imported by Iroquois/Delaware. Specifically, his resolution calls upon the Directors of Iroquois/Delaware to:

form a committee to study the methods by which its French supplier produces pâté de foie gras, and report to the shareholders its findings and opinions, based on expert consultation, on whether this production method causes undue distress, pain or suffering to the animals involved and, if so, whether further distribution of this product should be discontinued until a more humane production method is developed.

Attachment to Affidavit of Peter C. Lovenheim.

Mr. Lovenheim's right to compel Iroquois/Delaware to insert information concerning his proposal in the proxy materials turns on the applicability of § 14(a) of the Securities Exchange Act of 1934 . . . ("the Exchange Act"), and the shareholder proposal rule promulgated by the Securities and Exchange Commission ("SEC"), Rule 14a-8. That rule states in pertinent part:

If any security holder of an issuer notifies the issuer of his intention to present a proposal for action at a forthcoming meeting of the issuer's security holders, the issuer shall set forth the proposal in its proxy statement and identify it in its form of proxy and provide means by which security holders [presenting a proposal may present in the proxy statement a statement of not more than [500] words in support of the proposal].

Iroquois/Delaware has refused to allow information concerning Mr. Lovenheim's proposal to be included in proxy materials being sent in connection with the next annual shareholders meeting. In doing so, Iroquois/Delaware relies on an exception to the general requirement of Rule 14a-8, Rule 14a-8([i])(5). That exception provides that an issuer of securities "may omit a proposal and any statement in support thereof" from its proxy statement and form of proxy:

² Pâté de foie gras is made from the liver of geese. According to Mr. Lovenheim's affidavit, force-feeding is frequently used in order to expand the liver and thereby produce a larger quantity of pâté. Mr. Lovenheim's affidavit also contains a description of the force-feeding process:

Force-feeding usually begins when the geese are four months old. On some farms where feeding is mechanized, the bird's body and wings are placed in a metal brace and its neck is stretched. Through a funnel inserted 10-12 inches down the throat of the goose, a machine pumps up to 400 grams of corn-based mash into its stomach. An elastic band around the goose's throat prevents regurgitation. When feeding is manual, a handler uses a funnel and stick to force the mash down.

Affidavit of Peter C. Lovenheim at para. 7. Plaintiff contends that such force-feeding is a form of cruelty to animals. *Id.*

Plaintiff has offered no evidence that force-feeding is used by Iroquois/Delaware's supplier in producing the pâté imported by Iroquois/Delaware. However his proposal calls upon the committee he seeks to create to investigate this question.

if the proposal relates to operations which account for less than 5 percent of the issuer's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the issuer's business. . . .

II. LIKELIHOOD OF PLAINTIFF PREVAILING ON MERITS

...

C. Applicability of Rule 14a-8([i])(5) Exception

... [T]he likelihood of plaintiff's prevailing in this litigation turns primarily on the applicability to plaintiff's proposal of the exception to the shareholder proposal rule contained in Rule 14a-8([i])(5).

Iroquois/Delaware's reliance on the argument that this exception applies is based on the following information contained in the affidavit of its president: Iroquois/Delaware has annual revenues of \$141 million with \$6 million in annual profits and \$78 million in assets. In contrast, its *pâté de foie gras* sales were just \$79,000 last year, representing a net loss on *pâté* sales of \$3,121. Iroquois/Delaware has only \$34,000 in assets related to *pâté*. Thus none of the company's net earnings and less than .05 percent of its assets are implicated by plaintiff's proposal. These levels are obviously far below the five percent threshold set forth in the first portion of the exception claimed by Iroquois/Delaware.

Plaintiff does not contest that his proposed resolution relates to a matter of little economic significance to Iroquois/Delaware. Nevertheless he contends that the Rule 14a-8([i])(5) exception is not applicable as it cannot be said that his proposal "is not otherwise significantly related to the issuer's business" as is required by the final portion of that exception. In other words, plaintiff's argument that Rule 14a-8 does not permit omission of his proposal rests on the assertion that the rule and statute on which it is based do not permit omission merely because a proposal is not economically significant where a proposal has "ethical or social significance."³ . . .

The Court would note that the applicability of the Rule 14a-8([i])(5) exception to Mr. Lovenheim's proposal represents a close question given the lack of clarity in the exception itself. In effect, plaintiff relies on the word "otherwise," suggesting that it indicates the drafters of the rule

³ The assertion that the proposal is significant in an ethical and social sense relies on plaintiff's argument that "the very availability of a market for products that may be obtained through the inhumane force-feeding of geese cannot help but contribute to the continuation of such treatment." Plaintiff's brief characterizes the humane treatment of animals as among the foundations of western culture and cites in support of this view the Seven Laws of Noah, an animal protection statute enacted by the Massachusetts Bay Colony in 1641, numerous federal statutes enacted since 1877, and animal protection laws existing in all fifty states and the District of Columbia. An additional indication of the significance of plaintiff's proposal is the support of such leading organizations in the field of animal care as the American Society for the Prevention of Cruelty to Animals and The Humane Society of the United States for measures aimed at discontinuing use of force-feeding.

intended that other noneconomic tests of significance be used. Iroquois/Delaware relies on the fact that the rule examines other significance in relation to the issuer's business. Because of the apparent ambiguity of the rule, the Court considers the history of the shareholder proposal rule in determining the proper interpretation of the most recent version of that rule.

Prior to 1983, paragraph 14a-8([i])(5) excluded proposals "not significantly related to the issuer's business" but did not contain an objective economic significance test such as the five percent of sales, assets, and earnings specified in the first part of the current version. Although a series of SEC decisions through 1976 allowing issuers to exclude proposals challenging compliance with the Arab economic boycott of Israel allowed exclusion if the issuer did less than one percent of their business with Arab countries or Israel, the Commission stated later in 1976 that it did "not believe that subparagraph ([i])(5) should be hinged solely on the economic relativity of a proposal." Securities Exchange Act Release No. 12,999, 41 Fed. Reg. 52,994, 52,997 (1976). Thus the Commission required inclusion "in many situations in which the related business comprised less than one percent" of the company's revenues, profits or assets "where the proposal has raised policy questions important enough to be considered 'significantly related' to the issuer's business."

As indicated above, the 1983 revision adopted the five percent test of economic significance in an effort to create a more objective standard. Nevertheless, in adopting this standard, the Commission stated that proposals will be includable notwithstanding their "failure to reach the specified economic thresholds if a significant relationship to the issuer's business is demonstrated on the face of the resolution or supporting statement." Securities Exchange Act Release No. 19,135, 47 Fed. Reg. 47,420, 47,428 (1982). Thus it seems clear based on the history of the rule that "the meaning of 'significantly related' is not limited to economic significance." . . .

. . . The Court therefore holds that in light of the ethical and social significance of plaintiff's proposal and the fact that it implicates significant levels of sales, plaintiff has shown a likelihood of prevailing on the merits with regard to the issue of whether his proposal is "otherwise significantly related" to Iroquois/Delaware's business.¹⁶

ANALYSIS

1. Why did Lovenheim merely ask Iroquois Brands' board to form a study committee? Put another way, why didn't Lovenheim offer a proposal prohibiting the company from selling pâté?

¹⁶ The result would, of course, be different if plaintiff's proposal was ethically significant in the abstract but had no meaningful relationship to the business of Iroquois/Delaware as Iroquois/Delaware was not engaged in the business of importing pâté de foie gras.

2. Think about your favorite social or political cause. Suppose you wanted to get a shareholder proposal relating on that cause on a corporate proxy statement. Assume that the proposal would not meet the 5 percent economic significance test of Rule 14a-8(i)(5). On what basis would you show that the proposal has sufficient ethical or social significance to justify its inclusion in the proxy statement under *Lovenheim*?
3. Although Iroquois Brands contended that *Lovenheim*'s proposal might cause investors to conclude that the company was involved in cruelty to animals, the court dismissed that concern as "largely speculative." Was the court correct in giving such short shrift to this possibility?
4. The *Trinity* court stated that "a proposal that, out of concern for animal welfare, aims to limit which food items a grocer sells" can be excluded. Is that consistent with the *Lovenheim* decision?

increases the sales of its other models by consolidating its image as the producer of exciting cars.

PA (incorporated in Delaware) has received several shareholder proposals for this year's annual meeting. You are the firm's in-house lawyer. Your boss asks you whether she can exclude them:

Proposal A: Resolved, that the Company shall discontinue the Phaeton.

Proposal B: Resolved, that the shareholders recommend that the company discontinue the Phaeton.

Proposal C: Resolved, that the by-laws of the Company are hereby amended to include the following Section 12.2:

12.2 The Company shall produce no automobiles with a top speed of more than 100 m.p.h.

The proponents of A, B, and C argue simply that the company loses so much money on the Phaeton that it should stop producing it.

Section 109(a) of the Delaware General Corporation Law provides that by-laws may be adopted, amended, or repealed by the stockholders and, in addition by the directors if the certificate of incorporation so provides. Section 109(b) provides:

The by-laws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or power or the rights or powers of its stockholders, directors, officers or employees.

2. Your law firm is approached by a group of high-tech entrepreneurs about to form a corporation. They anticipate difficulties raising equity capital, and believe that investors will be more willing to buy stock if they (the investors) can readily remove incumbent managers. Toward that end, they propose including in the firm's articles of incorporation a provision much like that proposed in AIG. Would the provision be a good idea?

3. Your law firm is approached by another group of entrepreneurs who think investors are tired of the shareholder proposal system, and would like to contract out of it. Accordingly, they would like to include in their firm's articles of incorporation a provision that would allow management to refuse to include in its proxy solicitation material any proposal submitted by any shareholder. Suppose the provision is lawful. Who would lose if the firm were to adopt such a provision?

E. SHAREHOLDER INSPECTION RIGHTS

INTRODUCTION

Suppose you own shares of a firm you believe is badly managed. Suppose further that you want to communicate with the firm's other

shareholders about that mismanagement. Under the federal proxy rules, you may, as we have seen, be able to force the incumbent board to include a proposal you draft in its proxy solicitation materials. But suppose you want to elect your own slate of directors and thereby gain control of the corporation. You cannot require the corporation to include your slate in its solicitation materials, so you will need to do your own proxy solicitation. If you pay the costs you may be able to require the corporation to mail your solicitation materials. More precisely, under Rule 14a-7, the firm can choose either to mail your material and bill you for the costs or to give you the shareholder list instead. Most incumbent managements choose to mail the material themselves and keep the list confidential.

The well-counseled insurgent will be unwilling to rely on management's good offices. In a battle for control, information about shareholder identity may be crucial, for in such a battle you will not consider all shareholders alike. Instead, you will want to identify the holders of large blocks of stock and to spend most of your efforts trying to convince those major shareholders to support you. You will want the "shareholder list." Precisely because information about shareholder identity is valuable to you, incumbent managers are likely to resist your efforts to obtain it. There is nothing in the federal proxy rules requiring the corporation to give you the shareholder list, but the federal rules do not impair any rights you may have under state law. Thus, battles for the shareholder list are fought under state laws, as the cases in this section illustrate.

Crane Co. v. Anaconda Co.

39 N.Y.2d 14, 382 N.Y.S.2d 707, 346 N.E.2d 507 (1976).

In August, 1975, respondent Crane Company, an Illinois corporation, publicly announced a proposed offer to exchange up to 100 million dollars in subordinated debentures for as many as 5 million shares of common stock of the appellant Anaconda Company, a Montana corporation. This offer was vigorously opposed by Anaconda's management which sent four letters to shareholders asserting, *inter alia*, that the exchange offer was not in the best interests of Anaconda. Before the exchange offer could proceed Crane was obligated to file with the Securities and Exchange Commission a registration statement detailing the material facts of the offer in a prospectus. . . .

On November 19, 1975, Crane's registration statement became effective and Crane proceeded to distribute its prospectus to numerous brokers, dealers, commercial banks and trust companies for use in soliciting Anaconda stockholders. The next day Crane requested a copy of Anaconda's list of shareholders claiming that Anaconda had a fiduciary duty to its shareholders to present them with all the information

pertinent to the pending tender offer.* Crane owned no Anaconda stock at this time and Anaconda refused contending that there was no basis for Crane's request. However, as of December 11, 1975, approximately 2,350,000 Anaconda shares had been tendered to Crane, making Crane Anaconda's largest stockholder. The following day, a formal written demand to produce its stock book for inspection was made by Crane on Anaconda. This demand, accompanied by an affidavit stating that the inspection was "not desired for a purpose which is in the interest of a business or object other than the business of Anaconda," was made pursuant to section 1315 of the Business Corporation Law** and the common-law right to inspect corporate records. Anaconda rejected the demand but offered to mail Crane's prospectus to its shareholders at Crane's expense. . . .

In its petition Crane stated that it held in excess of 11% of Anaconda's common stock and that its request conformed to the requirements of the Business Corporation Law in that the inspection was not required for a purpose other than the business of Anaconda and that Crane had not participated in the sale of any stockholder list within the last five years. . . . Crane also stated in substance that it desired to communicate directly with its fellow stockholders to inform them of the terms of . . . its tender offer . . . , to reply to misleading statements issued and distributed by Anaconda to its stockholders, and thereby to dispel any misconceptions and facilitate the further tender of Crane debentures. Anaconda answered by asserting that Crane's alleged reasons for inspection were not purposes relating to the business of Anaconda within the meaning of section 1315 of the Business Corporation Law.

Special Term found that neither Crane's overriding purpose to further its tender offer nor its ancillary purposes were proper in this context and dismissed the petition. The Appellate Division reversed, with two Justices dissenting. The majority concluded that the matter was

* [Eds.—Tender offers are discussed at Chapter 7, Section 2.]

** [Eds.—The New York statute provided:

(a) Any resident of this state who shall have been a shareholder of record, for at least six months immediately preceding his demand, of a foreign corporation doing business in this state, or any resident of this state holding, or thereunto authorized in writing by the holders of, at least five percent of any class of the outstanding shares, upon at least five days' written demand may require such foreign corporation to produce a record of its shareholders setting forth the names and addresses of all shareholders, the number and class of shares held by each and the dates when they respectively became the owners of record thereof and shall have the right to examine . . . the record of shareholders or an exact copy thereof certified as correct by the corporate officer or agent responsible for keeping or producing such record and to make extracts therefrom. . . .

(b) An examination authorized by paragraph (a) may be denied to such shareholder or other person upon his refusal to furnish to the foreign corporation . . . an affidavit that such inspection is not desired for a purpose which is in the interest of a business or object other than the business of the foreign corporation and that such shareholder or other person has not within five years sold or offered for sale any list of shareholders of any corporation of any type or kind, whether or not formed under the laws of this state, or aided or abetted any person in procuring any such record of shareholders for any such purpose.]

proper being one of general interest to Anaconda's shareholders by virtue of their common interest in the corporation as shareholders. We agree with this determination.

Succinctly put, the issue here is whether a qualified stockholder may inspect the corporation's stock register to ascertain the identity of fellow stockholders for the avowed purpose of informing them directly of its exchange offer and soliciting tenders of stock. In our view this question should be answered in the affirmative. A shareholder desiring to discuss relevant aspects of a tender offer should be granted access to the shareholder list unless it is sought for a purpose inimical to the corporation or its stockholders—and the manner of communication selected should be within the judgment of the shareholder.

The significance of this appeal is evident in view of the fact that this right is the one most frequently litigated by stockholders . . . and the fact that the tender offer is the primary method of corporate acquisition. . . . The conceptual basis for this right is derived from the shareholder's beneficial ownership of corporate assets and the concomitant right to protect his investment. . . .

The present statute (Business Corporation Law, §§ 1315, 624) was enacted in 1961 and provid[es] that access [must] be permitted to qualified shareholders on written demand, subject to denial if the petitioner refused to furnish an affidavit that the "inspection is not desired for a purpose . . . other than the business" of the corporation and that the petitioner has not been involved in the sale of stock lists within the last five years (Business Corporation Law, § 1315, subd. [b]; § 624, subd. [c]). . . .

In attempting to sustain its burden of proof, appellant contends that inspection should not be compelled where the stockholder desires to obtain the identity of other stockholders to convince them to sell their stock, since this does not involve the business of the corporation. . . . We read this authority to compel the opposite conclusion.

Although everything affecting the shareholders will not affect the corporation, the converse is not true. Whenever the corporation faces a situation having potential substantial effect on its wellbeing or value, the shareholders qua shareholders are necessarily affected and the business of the corporation is involved within the purview of section 1315 of the Business Corporation Law. This statute should be liberally construed in favor of the stockholder whose welfare as a stockholder or the corporation's welfare may be affected. To say, as Anaconda would, that a pending tender offer involving over one fifth of the corporation's common stock is a purpose other than the business of the corporation is myopic. Since the pendency of such an exchange offer may well affect not only the future direction of the corporation but the continued vitality of the shareholders' investment, inspection of the stock book should be allowed so that qualified shareholders may have the means to independently evaluate the situation. Nor do we consider it significant that the

petitioning shareholder precipitated that which may affect the corporation or shareholders; the right adheres as one of property in the shareholder and one for the protection of that interest. . . .

Early in the proceedings Anaconda offered to have the corporation's transfer agent transmit the tender offer prospectus to all the stockholders. This was declined by Crane as much too expensive and not a productive way of soliciting tenders. . . . Obviously then, Crane was and is interested in pursuing a selective and direct approach by other means to stockholders. This is not by itself improper and is due to the pragmatics of soliciting tenders from likely prospects who hold sufficient shares. . . . Accordingly, since it appears that Anaconda has failed to sustain its burden of proving an improper purpose and it cannot be said that the court below abused its discretion, we conclude that inspection should be compelled.

*** State ex rel. Pillsbury v. Honeywell, Inc.**

291 Minn. 322, 191 N.W.2d 406 (1971).

Petitioner appeals from an order and judgment of the district court denying all relief prayed for in a petition for writs of mandamus to compel respondent, Honeywell, Inc., (Honeywell) to produce its original shareholder ledger, current shareholder ledger, and all corporate records dealing with weapons and munitions manufacture. We must affirm. . . .

Petitioner attended a meeting on July 3, 1969, of a group involved in what was known as the "Honeywell Project." Participants in the project believed that American involvement in Vietnam was wrong, that a substantial portion of Honeywell's production consisted of munitions used in that war, and that Honeywell should stop this production of munitions. Petitioner had long opposed the Vietnam war, but it was at the July 3rd meeting that he first learned of Honeywell's involvement. He was shocked at the knowledge that Honeywell had a large government contract to produce anti-personnel fragmentation bombs. Upset because of knowledge that such bombs were produced in his own community by a company which he had known and respected, petitioner determined to stop Honeywell's munitions production.

On July 14, 1969, petitioner ordered his fiscal agent to purchase 100 shares of Honeywell. He admits that the sole purpose of the purchase was to give himself a voice in Honeywell's affairs so he could persuade Honeywell to cease producing munitions. . . . In his deposition testimony petitioner made clear the reason for his purchase of Honeywell's shares:

"Q . . . [D]o I understand that you requested Mr. Lacey to buy these 100 shares of Honeywell in order to follow up on the desire you had to bring to Honeywell management and to stockholders these theses that you have told us about here today?

"A Yes. That was my motivation."

The "theses" referred to are petitioner's beliefs concerning the propriety of producing munitions for the Vietnam war. . . .

Prior to the instigation of this suit, petitioner submitted two formal demands to Honeywell requesting that it produce its original shareholder ledger, current shareholder ledger, and all corporate records dealing with weapons and munitions manufacture. Honeywell refused. . . .

In the deposition petitioner outlined his beliefs concerning the Vietnam war and his purpose for his involvement with Honeywell. He expressed his desire to communicate with other shareholders in the hope of altering Honeywell's board of directors and thereby changing its policy. To this end, he testified, business records are necessary to insure accuracy.

A hearing was held on January 8, 1970, during which Honeywell introduced the deposition, conceded all material facts stated therein, and argued that petitioner was not entitled to any relief as a matter of law. Petitioner asked that alternative writs of mandamus issue for all the relief requested in his petition. On April 8, 1970, the trial court dismissed the petition, holding that the relief requested was for an improper and indefinite purpose. Petitioner contends in this appeal that the dismissal was in error.

1. Honeywell is a Delaware corporation doing business in Minnesota.

...

Under the Delaware statute the shareholder must prove a proper purpose to inspect corporate records other than shareholder lists. Del.Code Ann. tit. 8, § 220. . . .*

* [Eds.—The statute provided:

(b) Any stockholder . . . shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose the corporation's stock ledger, a list of its stockholders, and its other books and records, and to make copies or extracts therefrom. A proper purpose shall mean a purpose reasonably related to such person's interest as a stockholder. . . .

(c) If the corporation . . . refuses to permit an inspection sought by a stockholder . . . pursuant to sub-section (b) or does not reply to the demand within five business days after the demand has been made, the stockholder may apply to the Court of Chancery for an order to compel such inspection. . . . The Court may summarily order the corporation to permit the stockholder to inspect the corporation's stock ledger, an existing list of stockholders, and its other books and records, and to make copies or extracts therefrom; or the Court may order the corporation to furnish to the stockholder a list of its stockholders as of a specific date on condition that the stockholder first pay to the corporation the reasonable cost of obtaining and furnishing such list and on such other conditions as the Court deems appropriate. Where the stockholder seeks to inspect the corporation's books and records, other than its stock ledger or list of stockholders, he shall first establish (1) that he has complied with the provisions of this section respecting the form and manner of making demand for inspection of such document; and (2) that the inspection he seeks is for a proper purpose. Where the stockholder seeks to inspect the corporation's stock ledger or list of stockholders and he has complied with the provisions of this section respecting the form and manner of

2. The trial court ordered judgment for Honeywell, ruling that petitioner had not demonstrated a proper purpose germane to his interest as a stockholder. Petitioner contends that a stockholder who disagrees with management has an absolute right to inspect corporate records for purposes of soliciting proxies. He would have this court rule that such solicitation is per se a "proper purpose." Honeywell argues that a "proper purpose" contemplates concern with investment return. We agree with Honeywell. . . .

The act of inspecting a corporation's shareholder ledger and business records must be viewed in its proper perspective. In terms of the corporate norm, inspection is merely the act of the concerned owner checking on what is in part his property. In the context of the large firm, inspection can be more akin to a weapon in corporate warfare. The effectiveness of the weapon is considerable:

"Considering the huge size of many modern corporations and the necessarily complicated nature of their bookkeeping, it is plain that to permit their thousands of stockholders to roam at will through their records would render impossible not only any attempt to keep their records efficiently, but the proper carrying on of their businesses."

. . . Because the power to inspect may be the power to destroy, it is important that only those with a bona fide interest in the corporation enjoy that power. . . .

Petitioner had utterly no interest in the affairs of Honeywell before he learned of Honeywell's production of fragmentation bombs. Immediately after obtaining this knowledge, he purchased stock in Honeywell for the sole purpose of asserting ownership privileges in an effort to force Honeywell to cease such production. We agree with the court in *Chas. A. Day & Co. v. Booth*, 123 Maine 443, 447, 123 A. 557, 558 (1924) that "where it is shown that such stockholding is only colorable, or solely for the purpose of maintaining proceedings of this kind, [we] fail to see how the petitioner can be said to be a 'person interested,' entitled as of right to inspect. . . ." But for his opposition to Honeywell's policy, petitioner probably would not have bought Honeywell stock, would not be interested in Honeywell's profits and would not desire to communicate with Honeywell's shareholders. His avowed purpose in buying Honeywell stock was to place himself in a position to try to impress his opinions favoring a reordering of priorities upon Honeywell management and its other shareholders. Such a motivation can hardly be deemed a proper purpose germane to his economic interest as a shareholder. . . .

We do not mean to imply that a shareholder with a bona fide investment interest could not bring this suit if motivated by concern with

making demand for inspection of such documents, the burden of proof shall be upon the corporation to establish that the inspection he seeks is for an improper purpose.]

the long-or short-term economic effects on Honeywell resulting from the production of war munitions. Similarly, this suit might be appropriate when a shareholder has a bona fide concern about the adverse effects of abstention from profitable war contracts on his investment in Honeywell.

In the instant case, however, the trial court, in effect, has found from all the facts that petitioner was not interested in even the long-term well-being of Honeywell or the enhancement of the value of his shares. His sole purpose was to persuade the company to adopt his social and political concerns, irrespective of any economic benefit to himself or Honeywell. This purpose on the part of one buying into the corporation does not entitle the petitioner to inspect Honeywell's books and records. . . .

The order of the trial court denying the writ of mandamus is affirmed.

QUESTIONS

1. Should companies be able to limit access to shareholder lists? Should shareholder lists be treated differently from the firm's financial records? From its other business documents? What costs might firms incur if forced to give unrestricted access to the shareholder lists?

2. Should a firm be able to expand or contract the shareholder inspection right?

3. If a shareholder has a "proper purpose" in demanding the shareholder list, should it matter that he or she may have other purposes? Suppose, for example, that the shareholder making the demand is a broker trying to open a mail-order investment consulting service.

4. In light of *Pillsbury*, how might you coach a client who wants access to corporate records for a political cause?



Sadler v. NCR Corporation

928 F.2d 48 (2d Cir.1991).

This appeal concerns a limited but potentially important tactic in proxy contests—a stockholder's demand for a list of record shareholders and a list of beneficial owners of shares who do not object to disclosure of their names ("NOBO list"). The appeal raises issues under New York state law and the United States Constitution as to the power of New York to require an out-of-state corporation, doing business within New York, to provide resident shareholders with the list of record stockholders and to compile and produce the NOBO list, under circumstances where the requesting shareholders could not obtain such lists under the law of the state of incorporation. The lists are sought in connection with a tender offer and the solicitation of proxy votes in an effort to replace directors. . . .

We conclude that New York law authorizes production of the shareholder and NOBO lists in the circumstances of this case and that application of New York law does not violate the Commerce Clause of the Constitution. . . .

Background

NCR, a large computer company, is incorporated in Maryland and has its principal place of business in Dayton, Ohio. It is undisputed that NCR maintains at least eight offices in New York and conducts substantial business there. NCR has 75,000 shareholders. AT & T, the well-known telecommunications company, is a New York corporation with its principal executive offices in New York City. AT & T became a beneficial owner of 100 shares of NCR stock on November 21, 1990. The Sadlers are New York residents who own more than 6,000 shares of NCR stock and have been record holders of NCR stock for more than six months prior to this lawsuit.

On December 6, 1990, AT & T began a tender offer for the shares of NCR, offering to purchase all of the common stock of NCR for \$90 a share. In compliance with Rule 14d-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.14d-5 (1990), NCR mailed the offer to purchase to all NCR stockholders. The NCR board rejected the tender offer and declined to redeem a "poison pill" shareholders' rights plan, which presented and continues to present an obstacle to a hostile tender offer.* AT & T responded to this opposition by soliciting NCR shareholders to convene a special meeting of stockholders to replace a majority of the NCR directors so that the barriers to the tender offer could be removed. Maryland law permits a special meeting of stockholders to be called upon the request of stockholders entitled to cast 25 percent of the votes at the meeting. Md. Corps. & Ass'ns Code Ann. § 2-502 (1985 & Supp. 1990). NCR's corporate charter permits directors to be replaced at a special meeting of stockholders upon the affirmative vote of 80 percent of all outstanding shares. Soon after soliciting calls for a special meeting, AT & T submitted to NCR requests for a special meeting from holders of more than half of NCR stock. NCR subsequently scheduled a special meeting for March 28, 1991, the date selected for its annual meeting.

Beginning in early January 1991, AT & T and the Sadlers, acting at AT & T's request, sought from NCR its stockholder list and related materials to facilitate communication with owners of NCR shares. In addition to the list of record owners, AT & T sought a magnetic computer tape of the list and daily transfer sheets showing changes in shareholders from the date of demand to the date of the annual meeting. AT & T also sought two other lists, a "CEDE list" and a "NOBO list." A "CEDE list" identifies the brokerage firms and other record owners who bought shares in a street name for their customers and who have placed those

* [Eds.—Poison pills are discussed at Chapter 7, Section 2(B).]

shares in the custody of depository firms such as Depository Trust Co.; these shares are reflected in the corporation's records only under the names of nominees used by such depository firms. Depository Trust Co. uses "Cede & Co." as the name of the nominee for shares it holds for brokerage firms, and such lists, regardless of the nominee names adopted by other depository firms, are known as "CEDE lists." . . . A "NOBO list" (non-objecting beneficial owners) contains the names of those owning beneficial interests in shares of a corporation who have given consent to the disclosure of their identities. The Securities and Exchange Commission requires brokers and other record holders of stock in street name to compile a NOBO list at a corporation's request. . . .

Upon NCR's refusal to produce the requested materials, the Sadlers and AT & T brought this suit in the Southern District, relying on section 1315 of the New York Business Corporation Law, N.Y. Bus. Corp. Law § 1315 (McKinney 1986). Section 1315, which we consider in detail below, enables New York residents owning shares of a foreign corporation to obtain a list of the corporation's shareholders. On January 28, 1991, the District Court ruled that the Sadlers qualified under section 1315 to obtain NCR's stockholder list and that the statute could constitutionally be applied to require NCR to comply with their request, notwithstanding NCR's Commerce Clause objections. Later that day, [the district court judge] issued a supplemental ruling rejecting NCR's contention that the NOBO list was not producible under section 1315 because it was not then in existence but required compilation. He entered an order requiring NCR to produce all the materials sought by the Sadlers and AT & T.

Discussion

I. Application of section 1315

Section 1315(a) permits any New York resident who for six months has been a stockholder of record of a foreign corporation doing business in New York, or who holds or acts for those who hold five percent of any class of outstanding shares to require the corporation, on five days' written notice, to produce "a record of its shareholders setting forth the names and addresses of all shareholders, the number and class of shares held by each and the dates when they respectively became the owners of record." N.Y. Bus. Corp. Law (McKinney 1986). Such a resident is also entitled "to examine in person or by agent . . . the record of shareholders" at specified locations. *Id.* The corporation may require the requesting shareholder to furnish an affidavit assuring that "inspection is not desired for a purpose . . . other than the business of" the corporation and that the shareholder has not engaged in the sale of stockholder lists within the past five years. *Id.* § 1315(b). A substantially similar provision of New York law applies to stockholder lists of New York corporations. N.Y. Bus. Corp. Law § 624 (McKinney 1986). See *Crane Co. v. Anaconda Co.*, 39 N.Y.2d 14, 18-20, 346 N.E.2d 507, 510-11, 382 N.Y.S.2d 707, 710-11 (1976) (outlining origin of the New York statutory right to inspect stockholder lists).

A. Eligibility of the Sadlers.

The Sadlers qualify under section 1315 as persons entitled to obtain a "record" of NCR's shareholders. The Sadlers are residents of New York and have owned NCR stock for six months prior to their demand. The corporation whose stockholder list they seek does business in New York.

Nevertheless, NCR challenges the Sadlers' right to invoke section 1315 because of the arrangement between the Sadlers and AT & T under which the Sadlers initiated their request. Since AT & T had not held its NCR stock for more than six months, it sought out a New York resident who qualified under section 1315. AT & T's agreement with the Sadlers provides that the Sadlers will demand the NCR stockholder list, that AT & T will reimburse the Sadlers for any expenses and indemnify them for any losses arising out of the demand, and that the Sadlers will not settle any claim or lawsuit concerning the demand without the consent of AT & T, which will not be unreasonably withheld. Pursuant to this agreement, the Sadlers requested that NCR produce the stockholder records to AT & T, which it characterized as "our agent," and informed NCR that AT & T would reimburse NCR for any expenses incurred in complying with the demand. NCR contends that AT & T is not the agent of the Sadlers, but in reality is the principal, using the Sadlers as its agent for a demand that AT & T itself is not entitled to make.

We agree with [the district court judge] that the agreement between the Sadlers and AT & T does not disqualify the Sadlers from invoking section 1315. Though section 1315 permits an "agent" to act for the qualifying New York resident in inspecting the shareholder record, it does not inevitably apply all the technical aspects of the law of agency to the permissible relationship between the requesting shareholder and another entity with whom the shareholder chooses to act. Section 1315 "should be liberally construed in favor of the stockholder," *Crane Co.*, 39 N.Y.2d at 20-21, 346 N.E.2d at 512, 382 N.Y.S.2d at 712. Once the resident shareholder alleges compliance with the statute, "the bona fides of the shareholder will be assumed . . . and it becomes incumbent on the corporation to justify its refusal by showing an improper purpose or bad faith." *Id.* at 20, 346 N.E.2d at 511, 382 N.Y.S.2d at 711 (citations omitted).

We see no reason to believe that New York would deny the Sadlers the right to invoke section 1315 because of the arrangement they have made with AT & T. . . .

B. The demand for the NOBO list.

Whether New York law entitles the Sadlers to require NCR to assemble a NOBO list presents a more substantial question. The parties agree that section 1315 applies to NOBO lists in a corporation's possession, but it is undisputed that at the time of the demand, NCR did not have a NOBO list in its possession. It is also undisputed that a corporation can obtain a NOBO list, normally within ten days, by

requesting compilation of the list by firms that offer data processing services for this task. NCR reads section 1315 as limited to production of lists in existence, as distinguished from those readily capable of being compiled. . . .

The text of section 1315 does not resolve the dispute, although a narrow reading of its terms might favor NCR. The statute could be read to be limited to production or examination of lists already in existence and could also be limited to lists reflecting the names and addresses of owners of record. But New York courts have made clear that the statute is to be "liberally construed," *Crane Co.*, 39 N.Y.2d at 20-21, 346 N.E.2d at 512, 382 N.Y.S.2d at 712, to "facilitate communication among shareholders on issues respecting corporate affairs," *Bohrer v. International Banknote Co.*, 150 A.D.2d 196, 540 N.Y.S.2d 445, 446 [(1st Dep't 1989)]. . . . A narrow reading of section 1315 would therefore not accord with New York law. . . .

Other courts, however, construing statutes similar to section 1315, have expressly declined to order compilation of NOBO lists. *RB Associates v. The Gillette Co.*, C.A. No. 9711, 1988 WL 27731 (Del.Ch., Mar.22, 1988); *Cenergy Corp. v. Bryson Oil & Gas P.L.C.*, 662 F.Supp. 1144, 1148 (D.Nev.1987). The matter was given extended consideration by Chancellor Allen in *RB Associates*. In declining to order compilation of a NOBO list, he distinguished it in two respect from CEDE lists, which Delaware and New York require a corporation to compile upon request of a qualified shareholder. . . . CEDE lists, he pointed out, can be generated rapidly by a computer, whereas a NOBO list takes up to ten days to compile. Second, he expressed the view that it would be extremely inefficient without a CEDE list to attempt to distribute proxy materials to persons for whom a depository company holds shares, whereas a NOBO list "plays no central role in a proxy contest." *RB Associates*, *supra*.

We do not find either distinction compelling. Since compilation of a NOBO list is a relatively simple mechanical task, the fact that compilation takes longer than for a CEDE list is an insubstantial basis for distinction. As to both sets of information, the underlying data exist in discrete records readily available to be compiled into an aggregate list. Nor are the functions of the lists significantly dissimilar. Both facilitate direct communication with stockholders, in the case of a NOBO list, at least with those beneficial owners who have indicated no objection to disclosure of their names and addresses.

Though Delaware chooses to construe the reach of its requirements on stockholder list disclosure narrowly in this respect, we think New York would construe section 1315 more generously. Once the Securities and Exchange Commission has acted to enable a corporation to obtain from brokers and other record owners a list of beneficial owners of its shares who do not object to such disclosure, we think New York would

apply section 1315 to permit a qualifying shareholder to require the compilation and production of such a list.

Even if the statute might not require compilation of NOBO lists routinely, . . . compilation was properly ordered in this case. The effect of NCR's 80 percent rule is to count as a "no" vote on the replacement of directors every share that is not voted at the special meeting. Thus, the shares of non-voting beneficial owners who might oppose management if solicited by management opponents armed with a NOBO list are counted in favor of management. Denying such opponents an opportunity to contact the NOBOs is inconsistent with the statute's objective of seeking "to the extent possible, to place shareholders on an equal footing with management in obtaining access to shareholders." *Bohrer*, 150 A.D.2d at 196-97, 540 N.Y.S.2d at 446. In effect, NCR already has the votes of those NOBOs who, for lack of solicitation, decline to vote. As to them, NCR has all the access it needs.

...

[NCR claimed] that section 1315 subjects it to inconsistent regulation of a sort that the dormant Commerce Clause power prohibits. . . . [S]tates have traditionally exercised authority to require disclosure of stockholder lists of foreign corporations doing business within their borders. Moreover, such authority will not normally create, and does not create in this case, the sort of irreconcilable conflict that would arise if a state purported to regulate voting rights or other aspects of the internal affairs of a foreign corporation that "admit only of one uniform system, or plan of regulation," *Cooley v. Board of Wardens*, 53 U.S. (12 How.) 299, 319 (1851). Access to stockholder lists is a recognized exception to the internal affairs doctrine as a matter of corporate law and conflicts of law, and it should take a substantial threat of conflict adversely affecting interstate commerce before a court invalidates a state's assertion of this traditional authority. Though Maryland may well have balanced limited shareholder access to stockholder lists with generous authority for calling special meetings, it did so against the background of traditional foreign state regulation of such access, and it cannot expect courts to provide constitutional insulation for the particular arrangements it adopted. If the traditional role of states concerning access to stockholder lists of foreign corporations is to be circumscribed, that alteration will have to be undertaken by Congress.

NCR's remaining Commerce Clause contentions require little discussion. Section 1315 creates no discrimination against interstate commerce. . . . [I]t applies (for all practical purposes) equally to foreign and domestic corporations. . . .

Equally unavailing is the claim that section 1315 imposes unjustified burdens on interstate commerce. . . .

AFTERMATH

Subsequent to the decision in *Sadler*, New York law was amended to provide that, in response to shareholder requests for information, "[t]he corporation shall not be required to obtain information about beneficial owners not in its possession." McKinney's Business Corporation Law § 1315(a).

PROBLEMS

McWindsor, Inc., which is incorporated in New York, is a maker of upscale British-style fashions. To date, it has specialized in \$1,000 all-cotton pea-green trench coats and \$100 all-cotton umbrellas. Both sport the distinctive McWindsor plaid fabric, said to have been designed for the kilts of an obscure Scottish regiment in 1656. McWindsor stock trades at about \$1,000 per share. Some shareholders have asked the company to perform a 10-for-1 stock split (each shareholder would tender his or her stock to the company, and receive 10 new shares of stock for each old share of stock). By doing so, the company would reduce the price of a share of McWindsor stock to about \$100. The shareholders explain that these lower share prices would let them more easily fit McWindsor shares into diversified stock portfolios. The company has refused. Far better, CEO Prince George McWindsor announces, for stock to trade at the price of a rain coat than for it to trade at the price of an umbrella.

1. Suppose X (a manufacturer of expensive sports cars) buys several shares of McWindsor stock and requests a shareholders list. Must McWindsor give X the list? What kind of list? Suppose X announces a sale/tender offer: it will exchange one sports car (generally selling at \$180,000) for every 150 shares of McWindsor stock tendered to X by McWindsor shareholders. If it again asks for the shareholder list, must McWindsor give it the list?
2. Suppose an investor holding three McWindsor shares asks for the shareholder list. He explains that he wants to contact other shareholders and ask them to join him in demanding that the company effect a stock split. Must McWindsor provide the list?
3. Suppose an investment bank holding 300 McWindsor shares asks for the list. It explains that its stock analysts have developed a new formula for fitting McWindsor shares into diversified stock portfolios. It thus wants to offer their services to McWindsor shareholders. Must McWindsor provide the list? Suppose instead that the investment bank forms a mutual fund called Diversified McWindsor, Inc. [DWI]. In exchange for several thousand shares of DWI stock, it has contributed several thousand shares of 20 companies that, together with McWindsor, form a well-diversified stock portfolio. DWI now announces a tender offer for McWindsor stock: in exchange for every McWindsor share tendered, it will provide 10 shares (each worth \$100) of DWI. In order to publicize

the tender offer, DWI asks for the shareholders list. Must McWindsor provide the list?

4. Suppose a group of shareholders ask for all records relating to the employment practices of McWindsor's supplier in Northern Ireland. The shareholders explain that they have heard rumors that McWindsor's supplier discriminates against Catholic workers, and want to ascertain whether the rumors are true. Must McWindsor provide the records?

2. SHAREHOLDER VOTING CONTROL

Stroh v. Blackhawk Holding Corp.

48 Ill.2d 471, 272 N.E.2d 1 (1971).

The only issue before this court is the validity of the 500,000 shares of Class B stock, which by the articles of incorporation of Blackhawk were limited in their rights by the provision "none of the shares of Class B stock shall be entitled to dividends either upon voluntary or involuntary liquidation or otherwise." It is the plaintiffs' contention that because of the foregoing limitation—depriving the Class B shares of the "economic incidents of shares of stock, or of the proportionate interest in the corporate assets—the Class B shares do not in fact constitute shares of stock.

Blackhawk Holding Corporation was organized under the Illinois Business Corporation Act in November of 1963. Its articles of incorporation authorized the issuance of 3,000,000 shares of Class A stock with a par value of \$1, and 500,000 shares of Class B stock without par value. . . . Pursuant to the preorganization subscription agreements, 21 promoters purchased 87,868 shares of the Class A stock at the price of \$3.40 per share (\$298,751.20), and the 500,000 shares of Class B stock at ¼ per share (\$1,250). Thereafter, the corporation registered the Class A shares with the securities division of the office of the Secretary of State of Illinois for the sale of 500,000 shares thereof to the general public at a price of \$4 per share. The prospectus for the registration described the Class A and Class B stock, and quoted from the articles of incorporation relative to their respective rights and preferences. The prospectus explained that every share of each class of stock would be entitled to one vote on all general matters submitted to a vote of the shareholders. . . .

The prospectus also explained that no Class B stock was being offered for sale in that all of such stock has been previously issued. Under the heading "Organization and Development," the prospectus also stated: "Subscriptions for a total of \$300,001.20 were sold to twenty-one persons, representing 87,868 class A shares, the class now being offered, at the price of \$3.40 per share (\$298,751.20) and 500,000 class B shares, at a price of one-fourth of a cent per share (\$1,250.00); thus said subscribers by virtue of a \$300,001.20 investment, have control of the corporation having an initial capitalization of \$2,000,000.00 after this offering."

In August of 1964, there was a 2 for 1 split of the Class A stock, increasing the shares outstanding from 587,863 to 1,175,736 shares. The corporation sold additional Class A stock to the public in 1965 for \$4 a share. As of June 1968, there were 1,237,681 Class A shares and 500,000 Class B shares outstanding, the latter representing 28.78% of the total voting shares of the company.

...

Under the Illinois constitution of 1870, a stockholder in an Illinois corporation is guaranteed the right to vote based upon the number of shares owned by him. (Ill. Const. art. XI, sec. 3, S.H.A.) Section 14 of the Business Corporation Act (Ill. Rev. Stat. 1969, ch. 32, par. 157.14) provides that shares of stock in an Illinois corporation may be divided into classes,

"with such designations, preferences, qualifications, limitations, restrictions and such special or relative rights as shall be stated in the articles of incorporation. The articles of incorporation shall not limit or deny the voting power of the shares of any class."

Without limiting the authority herein contained, a corporation when so provided in its articles of incorporation, may issue shares of preferred or special classes:

...

(c) Having preference over any other class or classes of shares as to the payment of dividends.

(d) Having preference as to the assets of the corporation over any other class or classes of shares upon the voluntary or involuntary liquidation of the corporation."

...

Section 2.6 of the Act, in defining "shares" states, "'Shares' means the units into which the proprietary interests in a corporation are divided." (Ill. Rev. Stat. 1969, ch. 32, par. 157.2-6.) This was formerly section 2(f) of the Act (Ill. Rev. Stat. 1955, ch. 32, par. 157.2(f)) which defined shares as "units into which shareholders' rights to participate in the control of a corporation, in its surplus or profits, or in the distribution of its assets, are divided."...

To the plaintiffs, "proprietary," as used in the definition of shares, means a property right, and shares must then represent some economic interest, or interest in the property or assets of the corporation. However, the word "proprietary" does not necessarily denote economic or asset rights, although it has been defined as synonymous with ownership or to denote legal title... and "proprietary rights" have been defined as those conferred by virtue of ownership of a thing....

We agree with the defendants' construction. We interpret this statutory definition to mean that the proprietary rights conferred by the ownership of stock may consist of one or more of the rights to participate

"in the control of the corporation, in its surplus or profits, or in the distribution of its assets." The use of the disjunctive conjunction "or" indicates that one or more of the three named rights may inure to a stockholder by virtue of his stock ownership. . . .

We must here decide the extent to which economic attributes of shares of stock may be eliminated. . . .

Section 14 of the Act clearly expresses the intent of the legislature to be that parties to a corporate entity may create whatever restrictions and limitations they may want with regard to their corporate stock by expressing such restrictions and limitations in the articles of incorporation. These rights and powers granted by the legislature to the corporation to make the terms of its contract with its shareholders are limited only by the proviso that the articles may not limit or deny the voting power of any share. This section of the Act expressly confers the right to prefer a class of shares over another with regard to dividends and assets. Section 2.6 defines shares as "The units into which the proprietary interests in a corporation are divided."

In seeking the intent of the legislature, a statute should be construed as a whole and its separate parts considered together. Our present constitution requires only that a shareholder not be deprived of his voice in management. It does not require that a shareholder, in addition to the management aspect of ownership, must also have an economic interest.

Thus, section 14, like the constitution, limits the power of a corporation only as to the voting aspect of ownership. . . .

When the relevant sections of the Act are read together with the constitution, it seems apparent that it was the intent of the legislature that the proprietary interests represented by the shares of stock consist of management or control rights, rights to earnings, and rights to assets. There are other rights which are incidental to these. Under our laws, the rights to earnings and the rights to assets—the "economic" rights—may be removed and eliminated from the other attributes of a share of stock. Only the management incident of ownership may not be removed.

...

The constitution requires only that the right to vote be proportionate to the number of shares owned, not to the investment made in a corporation. It has long been the common practice in Illinois to classify shares of stock such that one may invest less than another in a corporation, and yet have control. One . . . shareholder may purchase ten shares of a class of stock issued at its par value of \$1,000 per share, and his business partner may purchase 100 shares of another class of the corporate stock issued at its par value of \$10 per share. The parties, for varying reasons, may be very willing that the party investing the \$1,000 have control of the management of the corporation, as opposed to the party having the investment of \$10,000. . . .

If there is overreaching or fraud in establishing the different relative voting rights of shares, that is another matter and there is a remedy available. We are aware that the classification of shares, so as to enable one class to obtain greater voting rights with the same or lesser investment in a corporation than another class, may carry with it the possibility for wrongdoing. However, it also often serves a valid purpose and there is nothing inherently wrong in such a scheme. The fact that a corporation makes a public offering of stock does not render the procedure outlined above less valid. The securities division of the Secretary of State's office has its particular guidelines to protect the public in such an offering.

In this case the parties went one step further than is customary. The stock which could be bought cheaper, and yet carry the same voting power per share, was not permitted to share at all in the dividends or assets of the corporation. This additional step did not invalidate the stock.

We find nothing in the declared public policy of this State to condemn stock of this nature. . . .

Affirmed and remanded, with directions.

■ SCHAEFER, JUSTICE (dissenting). L

...
"Under our laws," say the majority, "the rights to earnings and the rights to assets—the 'economic' rights—may be removed and eliminated from the other attributes of a share of stock. Only the management incident of ownership may not be removed." This seems to me to be saying that the ownership incidents of ownership may be eliminated. What remains, then, is a disembodied right to manage the assets of a corporation, divorced from any financial interest in those assets except such as may accrue from the power to manage them. In my opinion, what is left after the economic rights are "removed and eliminated" is not a share of corporate stock under the law of Illinois.

...

ANALYSIS

1. What might be the public policy underlying a prohibition of nonvoting shares? Would that policy also be offended by shares with unequal voting power?

2. The opinion of the lower appellate court in *Stroh* reveals that in 1967 the Class A shares were selling for substantially less than the \$4 per share initial offering price. At the same time, the Class B shares were selling for "about 20 times the original price." 253 N.E.2d 692, at 694. Does this tend to show that the initial investors in Class A shares were treated unfairly? Why would the Class B shares have any value at all? How would you determine what the value is?

3. At the time this case arose, the Illinois constitution contained provisions that in effect required all common shares to have equal voting rights. In a 1970 constitutional revision, these requirements were dropped. The Illinois Business Corporation Act of 1983, § 7.40(b), now provides that corporations, in their articles, "may limit or deny voting rights or may provide special voting rights as to any class or classes or series of shares." Under this law, how might the original 21 investors in Blackhawk Holding Corp. have accomplished their apparent purpose (voting control disproportionate to profit claim) without using the peculiar Class B shares?

4. The original 21 investors in Blackhawk Holding Corp. obviously wanted to protect their control. One reason why people want control is that they (or their relations or friends) are, or expect to be, employed by the corporation and they want to protect their salaries and perquisites. To that extent, their interests may diverge from the interests of other shareholders. Are there reasons for wanting control that do not involve such blatant conflict of interest?

5. Suppose you have money to invest and are offered shares in a corporation with a control structure like that of Blackhawk Holding Corp. Suppose you believe that the people who will hold disproportionately large voting control will use their control to provide themselves and their children with jobs at salaries above the market rate and that there is no reasonable prospect that there will be anything you can do about it. Might you still be willing to buy shares in the corporation?

NOTE AND QUESTIONS

In *Providence and Worcester Co. v. Baker*, 378 A.2d 121 (Del.1977), the plaintiff owned 28 percent of the single class of voting shares of the Providence and Worcester Company (P & W). The corporation's articles of incorporation provided that "each shareholder shall be entitled to one vote for every share of the common stock of said company owned by him not exceeding fifty shares, and one vote for every twenty shares more than fifty owned by him; provided, that no stockholder shall be entitled to vote upon more than one fourth part of the whole number of shares issued and outstanding. . . ." The result of this provision was that the plaintiff, with 28 percent of the shares, had only 3 percent of the votes. The plaintiff argued that the corporation's voting rule violated § 151(a) of the Delaware corporation law, which provides that corporations may issue various classes or series of stock, "which classes or series may have such voting powers, full or limited, or no voting powers . . . as shall be stated and expressed in the certificate of incorporation." The plaintiff argued that this section of the Delaware law allows differences in voting power between classes of stock but not within a single class of stock and that, consequently, the P & W voting rule was impermissible. The Delaware Supreme Court rejected this argument and upheld the P & W rule.

Assume that at the time of its formation, P & W issued 35,000 shares and no shareholder held more than 200 shares. What legitimate purpose might be served by a voting rule like that of P & W? As a potential original investor in 100 of the P & W shares, what potential harm to your interests might you be concerned about as a result of the rule?

PROBLEM

Suppose a corporation is formed with 1 million Class A common shares, which are sold at \$4 per share. No other shares are outstanding. Two years later the shares are selling on the market for \$6 per share. The managers of the corporation own 300,000 shares and control the board of directors. The board adopts the following plan: For each share of Class A stock that a shareholder owns, he or she will be entitled to buy either (i) one additional share of Class A Stock at \$5.00 per share or (ii) five shares of a new Class B stock at 1 cent per share. The Class B shares will carry one vote per share but will be entitled to no dividends (current or liquidating). All the members of the management group will buy Class B shares. They will therefore wind up with their original Class A shares (300,000 votes) plus 1,500,000 Class B shares (1,500,000 votes). Suppose you own 1,000 of the original shares (to become Class A shares). You believe that there is a group of outside investors that would be willing to buy the entire corporation for \$9 million (\$9 per share for the existing shares). In fact, you believe that the reason for the board's plan to offer the new shares is its concern about the outside group taking over. (a) If the time comes when you must decide whether to buy new A shares or B shares, or neither, what will you do? (b) Do you think the board should be allowed to put you to this choice? (c) Suppose you had been entitled to vote on whether the new Class B shares should have been authorized. How would you have voted?

Espinoza v. Zuckerberg

124 A.3d 47 (Del. Ch. 2015).

... In this derivative action, a stockholder of Facebook, Inc. challenges the decision of Facebook's board of directors in 2013 to approve compensation for its outside, non-management directors, who comprised six of the eight directors on Facebook's board at the time... [The two "inside" directors were Chief Executive Officer Mark Zuckerberg and Chief Operating Officer Sheryl K. Sandberg.]

The parties agree that the board's decision to approve the 2013 compensation would be governed by the entire fairness standard of review ... as a self-dealing transaction. After the filing of this lawsuit, however, Mark Zuckerberg, who did not receive the disputed 2013 compensation and who controlled over 61% of the voting power of Facebook's common stock, expressed his approval of the 2013 compensation for the non-management directors in a deposition and an

affidavit. . . . The fundamental issue here is whether Zuckerberg's approvals were in a form sufficient to constitute stockholder ratification. . . .

The controlling stockholder of a Delaware corporation wields significant power. . . . But a controlling stockholder should not, in my view, be immune from the required formalities that come with such power. Although traditional agency law allows a principal to ratify an agent's conduct through informal assent, this tradition is ill-suited to the context of corporate law ratification, where formal structures govern the collective decision-making of stockholders who coexist as principals. These formalities serve to protect the corporation and all of its stockholders by . . . promoting transparency, particularly for non-assenting stockholders. I therefore conclude that stockholders of a Delaware corporation—even a single controlling stockholder—cannot ratify an interested board's decisions without adhering to the corporate formalities specified in the Delaware General Corporation Law for taking stockholder action.

Given this conclusion, the entire fairness standard applies to the board's approval of the 2013 compensation. As such, and given that defendants have not thus far demonstrated that the directors' compensation decisions were entirely fair, their motion for summary judgment is denied. Plaintiff has failed to state a reasonably conceivable claim for waste, however, and thus that claim is dismissed. . . .

I. BACKGROUND

Nominal Defendant Facebook, Inc. ("Facebook" or the "Company") is a Delaware corporation with headquarters in California. . . . Its Class B common stock has ten votes per share and its Class A common stock has one vote per share. Defendant Mark Zuckerberg is the founder of Facebook. Zuckerberg has served as Facebook's Chief Executive Officer since July 2004 and as the Chairman of Facebook's board of directors since January 2012. Zuckerberg, principally due to his ownership of the super-voting Class B shares, controlled approximately 61.6% of the total voting power of Facebook's common stock as of February 28, 2014. . . .

On August 21, 2013, the Compensation Committee, . . . discussed the compensation of Facebook's non-management directors. The following day, Facebook's board considered the topic at a regular meeting and unanimously approved a proposal . . . to provide non-employee directors with annual RSU grants at a value of \$300,000 per year

On June 6, 2014, plaintiff filed a derivative complaint on behalf of Facebook against the eight members of its board of directors. . . . On August 18, 2014, defendants moved for summary judgment On the same day, Zuckerberg filed an affidavit in support of the summary judgment motion declaring as follows:

10. Regardless of the capacity in which I have considered the issue, my view of the compensation of Facebook's Non-Executive Directors has never changed. I approve of all 2013 equity awards to Facebook's Non-Executive Directors, as well as Facebook's plan for compensation of Non-Executive Directors going forward (pursuant to the Annual Compensation Program). . . .

11. Although I was never presented with an opportunity to approve formally the 2013 equity awards to Facebook's Non-Executive Directors or the Annual Compensation Program in my capacity as a Facebook stockholder, had an opportunity presented itself, I would have done so. If put to a vote, I would vote in favor of the 2013 equity awards to Facebook's Non-Executive Directors, as well as the Annual Compensation Program, and if presented with a stockholder written consent approving them, I would sign it.

II. LEGAL ANALYSIS

Directors are necessarily interested in their compensation, which is a benefit they receive that does not accrue to stockholders generally. Thus, where, as here, directors make decisions about their own compensation, those decisions presumptively will be reviewed as self-dealing transactions under the entire fairness standard rather than under the business judgment rule. A decision dominated by interested directors can gain the protection of the business judgment rule, however, if a fully-informed disinterested majority of stockholders ratifies the transaction. At that point, the doctrinal standard of review becomes one of waste.*

Here, defendants contend that the business judgment rule should apply to their approval of the 2013 Compensation on the theory that Zuckerberg, who indisputably holds a majority of the voting power of

* [Eds.—In *Zupnick v. Goizueta*, 698 A.2d 384, 387 (Del. Ch. 1997), the court explained that:

To state a cognizable claim for waste . . . , the well-pleaded allegations of the complaint must support the conclusion that "no person of ordinary, sound business judgment would say that the consideration received for the options was a fair exchange for the options granted." *Michelson v. Duncan*, Del.Supr., 407 A.2d 211, 224 (1979). That is "an extreme test, very rarely satisfied by a shareholder plaintiff," because "if under the circumstances any reasonable person might conclude that the deal made sense, then the judicial inquiry ends." *Steiner v. Meyerson*, Del. Ch., C.A. No. 13139, Allen, C. (July 18, 1995), Mem. Op. at 2, 1995 WL 441999. As Chancellor Allen observed in *Steiner*, supra at p. 11:

[T]he waste theory represents a theoretical exception to the statement very rarely encountered in the world of real transactions. There surely are cases of fraud; of unfair self dealing and, much more rarely negligence. But rarest of all—and indeed like *Nessie*, possibly non-existent—would be the case of disinterested business people making non-fraudulent deals (non-negligently) that meet the legal standard of waste!]

Facebook's common stock, and who did not receive any of the 2013 Compensation, ratified the 2013 Compensation in his capacity as a Facebook stockholder by virtue of statements he made in his affidavit and his deposition after this action was filed. Plaintiff responds that these acts do not constitute a valid form of stockholder ratification . . . because Zuckerberg did not express assent as a stockholder in a manner permitted by the Delaware General Corporation Law ("DGCL"). . . .

The DGCL provides two methods for stockholders to express assent on a matter concerning the affairs of the corporation: (1) by voting in person or by proxy at a meeting of stockholders, or (2) by written consent. . . .

Before 1937, . . . stockholders of Delaware corporations could express assent only by voting in person or by proxy at a meeting of stockholders. . . .

In 1937, the DGCL was amended to permit stockholders to approve by unanimous written consent any action that was required to be taken, or that could be taken, at an annual or special meeting of stockholders. In 1967, the statute was further amended to remove the unanimity requirement for companies that chose to waive the requirement in their certificate of incorporation. In 1969, non-unanimous consent became the default rule rather than an option requiring an enabling charter provision. Although taken for granted now, non-unanimous written consent troubled the prominent drafter of the 1967 revision of the DGCL, who saw the potential for abuse.⁴⁷ Today, under Section 228 of the DGCL, unless the certificate of incorporation restricts the use of written consents, any action that may be taken at any annual or special meeting of stockholders may be taken by majority stockholder consent (or whatever other voting threshold applies for a particular act) "without a meeting, without prior notice and without a vote."

Significantly, although Section 228 permits stockholders to take action by written consent without prior notice, "[p]rompt notice of the taking of the corporate action" by written consent must be provided to the non-consenting stockholders. Thus, Section 228 ensures some level of transparency for non-consenting stockholders. Indeed, this Court has refused to make a written consent effective under Section 228 when the consenting stockholders failed to provide the required prompt notice to the non-consenting stockholders, until the failure to provide notice was remedied.

This Court has recognized more broadly that, "[b]ecause Section 228 permits immediate action without prior notice to minority stockholders, the statute involves great potential for mischief and its requirements

⁴⁷ See Ernest L. Folk, III, *Corporation Law Developments*—1969, 56 Va. L.Rev. 755, 783 (1970) ("It is apparent that this procedure can be abused where a large block of stock is held in a conveniently small number of hands. It permits the control block to take action in virtual secrecy and then present the minority shareholders with a fait accompli when it fulfills the minimal state statutory obligation of giving them 'prompt' notice of the action taken.").

must be strictly complied with if any semblance of corporate order is to be maintained.”⁵¹ . . . Thus, even if a controlling stockholder manifests a clear intent to ratify a decision outside of a stockholder meeting, the ratification will not be effective unless it complies with the technical requirements of Section 228. . . .

Defendants observe that there “is no case or statute that requires a stockholder vote or written consent for ratification purposes if the approval of a stockholder majority can be expressed another way.” Although no case has been identified that explicitly precludes (or permits) the use of informal means to ratify an act in a case like this, it is notable that many Delaware courts that have used stockholder ratification to apply the business judgment rule . . . have done so when the act of ratification occurred at a formal meeting of stockholders. More importantly, references in existing case law to ratification in the context of a stockholder “vote,” . . . support the conclusion that adherence to formalities should be required in this context.

One foundational case is *Gantler v. Stephens*.⁷⁹ . . . In *Gantler*, the Supreme Court held that the scope of “the shareholder ratification doctrine must be limited . . . to circumstances where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective.”⁸¹ In my view, *Gantler*’s use of the phrase “fully informed shareholder *vote*” in defining the concept of ratification was deliberate and was not intended to mean something less formal than an actual stockholder vote (or an action by written consent in lieu thereof).

Recently, in *Corwin v. KKR*, which confirmed that stockholder approval from a statutorily required vote can be used to invoke the business judgment rule the same way an approval from a voluntary vote can, the Supreme Court again used specific voting language to explain the doctrine of ratification in the corporate context.⁸³ Specifically, the Supreme Court stated that “the doctrine applies only to fully informed, uncoerced stockholder votes,” thereby implicitly excluding less formal methods of stockholder approval.⁸⁴

Another example is 8 Del. C. § 144(a)(2), which prevents the voiding of a director’s interested transaction if the “transaction is specifically approved in good faith by vote of the stockholders.” In describing that process, this Court stated in *Wheelabrator* that “[a]pproval by fully informed, disinterested shareholders pursuant to § 144(a)(2) invokes the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the

⁵¹ *Carsanaro v. Bloodhound Techs., Inc.*, 65 A.3d 618, 641 (Del. Ch. 2013) (internal quotation marks omitted).

⁷⁹ *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

⁸¹ *Gantler*, 965 A.2d at 713.

⁸³ [*Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304, 312–14 (Del. 2015).]

⁸⁴ *See id.*

transaction.”⁸⁶ Although the statutory language plainly refers to the need for a “vote of the stockholders,” *Wheelabrator* simply uses the word approval to indicate this formal requirement, suggesting again that Delaware courts naturally assume that stockholder approval requires adherence to formalities.⁸⁷

Failing to adhere to corporate formalities to effect stockholder ratification ... impinges on the rights of minority stockholders. In traditional agency relationships, a single principal's ratification of an agent's conduct comes at a cost to that principal only. But in the corporate context, the ratification decisions of a controlling stockholder affect the minority stockholders. Although minority stockholders have no power to alter a controlling stockholder's binding decisions absent a fiduciary breach, they are entitled to the benefits of the formalities imposed by the DGCL, including prompt notification under Section 228(e). This requirement promotes transparency and enables minority stockholders to stay abreast of corporate decision-making and maintain the accountability of boards of directors and controlling stockholders. ...

It is therefore of no moment that Zuckerberg undisputedly controls Facebook. Although he can outvote all other stockholders and thus has the power to effect any stockholder action he chooses, he still must adhere to corporate formalities (and his fiduciary obligations) when doing so. ...

ANALYSIS

1. What are the costs and benefits of after-the-fact notification allowed by DGCL § 228(e), in this case and in general? Does it matter that the corporation in this case was publicly held rather than closely held?

2. DGCL § 228(a) provides in pertinent part that:

Unless otherwise provided in the certificate of incorporation, any action required by this chapter to be taken at any annual or special meeting of stockholders of a corporation, or any action which may be taken at any annual or special meeting of such stockholders, may be taken without a meeting, without prior notice and without a vote, if a consent or consents in writing, setting forth the action so taken, 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

⁸⁶ [In re *Wheelabrator Techs., Inc. S'holders Litig.*, 663 A.2d 1194, 1198 (Del. Ch. 1995) (emphasis added) (internal quotation marks omitted).]

⁸⁷ In the analogous context of Section 144(a)(1), which allows for approval of interested transactions by fully informed, disinterested directors, this Court has suggested that such approval must occur at a formal meeting of directors. See *Lewis v. Fuqua*, 502 A.2d 962, 970 (Del. Ch. 1985) (noting party's concession that 8 Del. C. § 144 did not apply because “the approval did not take place at a formal Board meeting or necessarily after full disclosure of all material facts”).

at a meeting at which all shares entitled to vote thereon were present and voted and shall be delivered to the corporation

Suppose Acme, Inc., CEO and Chairman of the Board of Directors Malcolm Reynolds owns 498,000 of the 1 million outstanding shares of Acme common stock. Reynolds wants Acme's bylaws to be amended. DGCL § 261(2) provides that "In all matters other than the election of directors, the affirmative vote of the majority of shares present in person or represented by proxy at the meeting and entitled to vote on the subject matter shall be the act of the stockholders" Does Reynolds own enough shares to effect an amendment to the bylaws via a written consent without a shareholder meeting and without obtaining written consents from any other shareholders?

3. MBCA § 7.04(a) provides that:

Action required or permitted by this Act to be taken at a shareholders' meeting may be taken without a meeting if the action is taken by all the shareholders entitled to vote on the action. The action must be evidenced by one or more written consents bearing the date of signature and describing the action taken, signed by all the shareholders entitled to vote on the action and delivered to the corporation for filing by the corporation with the minutes or corporate records.

Subsection (b) allows the corporation to adopt a provision in the Articles of Incorporation authorizing non-unanimous written consents: "if consents in writing setting forth the action so taken are signed by the holders of outstanding shares having not less than the minimum number of votes that would be required to authorize or take the action at a meeting at which all shares entitled to vote on the action were present and voted"

What are the advantages and disadvantages of each approach?

4. If the Zuckerberg case goes to trial, what do you suppose is the likelihood that the plaintiff will prevail? What weight, if any, should be given to Zuckerberg's approval?

5. For the year 2013 Zuckerberg's salary was reduced to \$1. Suppose instead that his salary, approved by the board, had been substantial (as it had been in 2012). How, if at all, would that have changed the case?

6. Why did the court not require before-the-fact notification of the planned ratification?

7. Is the outcome consistent with *Bayer v. Beran*? With *Broz*?

3. CONTROL IN CLOSELY HELD CORPORATIONS

Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling

29 Del.Ch. 610, 53 A.2d 441 (Del.Sup.Ct.1947).

The Court of Chancery was called upon to review an attempted election of directors at the 1946 annual stockholders meeting of the corporate defendant. The pivotal questions concern an agreement between two of the three present stockholders, and particularly the effect of this agreement with relation to the exercise of voting rights by these two stockholders. At the time of the meeting, the corporation had outstanding 1000 shares of capital stock held as follows: 315 by petitioner Edith Conway Ringling; 315 by defendant Aubrey B. Ringling Haley (individually or as executrix and legatee of a deceased husband); and 370 by defendant John Ringling North. The purpose of the meeting was to elect the entire board of seven directors. The shares could be voted cumulatively. Mrs. Ringling asserts that by virtue of the operation of an agreement between her and Mrs. Haley, the latter was bound to vote her shares for an adjournment of the meeting, or in the alternative, for a certain slate of directors. Mrs. Haley contends that she was not so bound for reason that the agreement was invalid, or at least revocable.

The two ladies entered into the agreement in 1941. It makes like provisions concerning stock of the corporate defendant and of another corporation, but in this case, we are concerned solely with the agreement as it affects the voting of stock of the corporate defendant. The agreement recites that each party was the owner "subject only to possible claims of creditors of the estates of Charles Ringling and Richard Ringling, respectively" (deceased husbands of the parties), of 300 shares of the capital stock of the defendant corporation; that in 1938 these shares had been deposited under a voting trust agreement which would terminate in 1947, or earlier, upon the elimination of certain liability of the corporation; that each party also owned 15 shares individually; that the parties had "entered into an agreement in April 1934 providing for joint action by them in matters affecting their ownership of stock and interest in" the corporate defendant; that the parties desired "to continue to act jointly in all matters relating to their stock ownership or interest in" the corporate defendant (and the other corporation). The agreement then provides as follows:

"Now, Therefore, in consideration of the mutual covenants and agreements hereinafter contained the parties hereto agree as follows:

...

"2. In exercising any voting rights to which either party may be entitled by virtue of ownership of stock or voting trust certificates held by them in either of said corporations, each party will consult and confer

with the other and the parties will act jointly in exercising such voting rights in accordance with such agreement as they may reach with respect to any matter calling for the exercise of such voting rights.

④ "3. In the event the parties fail to agree with respect to any matter covered by paragraph 2 above, the question in disagreement shall be submitted for arbitration to Karl D. Loos, of Washington, D.C. as arbitrator and his decision thereon shall be binding upon the parties hereto. Such arbitration shall be exercised to the end of assuring for the respective corporations good management and such participation therein by the members of the Ringling family as the experience, capacity and ability of each may warrant. The parties may at any time by written agreement designate any other individual to act as arbitrator in lieu of said Loos. . . .

"5. This agreement shall be in effect from the date hereof and shall continue in effect for a period of ten years unless sooner terminated by mutual agreement in writing by the parties hereto.

" . . . "

The Mr. Loos mentioned in the agreement is an attorney and has represented both parties since 1937, and, before and after the voting trust was terminated in late 1942, advised them with respect to the exercise of their voting rights. At the annual meetings in 1943 and the two following years, the parties voted their shares in accordance with mutual understandings arrived at as a result of discussions. In each of these years, they elected five of the seven directors. Mrs. Ringling and Mrs. Haley each had sufficient votes, independently of the other, to elect two of the seven directors. By both voting for an additional candidate, they could be sure of his election regardless of how Mr. North, the remaining stockholder, might vote.¹

Some weeks before the 1946 meeting, they discussed with Mr. Loos the matter of voting for directors. They were in accord that Mrs. Ringling should cast sufficient votes to elect herself and her son; and that Mrs. Haley should elect herself and her husband; but they did not agree upon a fifth director. The day before the meeting, the discussions were continued, Mrs. Haley being represented by her husband since she could not be present because of illness. In a conversation with Mr. Loos, Mr. Haley indicated that he would make a motion for an adjournment of the meeting for sixty days, in order to give the ladies additional time to come to an agreement about their voting. On the morning of the meeting, however, he stated that because of something Mrs. Ringling had done, he

① ¹ Each lady was entitled to cast 2205 votes (since each had the cumulative voting rights of 815 shares, and there were 7 vacancies in the directorate). The sum of the votes of both is 4410, which is sufficient to allow 882 votes for each of 5 persons. Mr. North, holding 370 shares, was entitled to cast 2590 votes, which obviously cannot be divided so as to give to more than two candidates as many as 882 votes each. It will be observed that in order for Mrs. Ringling and Mrs. Haley to be sure to elect five directors (regardless of how Mr. North might vote) they must act together in the sense that their combined votes must be divided among five different candidates and at least one of the five must be voted for by both Mrs. Ringling and Mrs. Haley.

would not consent to a postponement. Mrs. Ringling then made a demand upon Mr. Loos to act under the third paragraph of the agreement "to arbitrate the disagreement" between her and Mrs. Haley in connection with the manner in which the stock of the two ladies should be voted. At the opening of the meeting, Mr. Loos read the written demand and stated that he determined and directed that the stock of both ladies be voted for an adjournment of sixty days. Mrs. Ringling then made a motion for adjournment and voted for it. Mr. Haley, as proxy for his wife, and Mr. North voted against the motion. Mrs. Ringling (herself or through her attorney, it is immaterial which) objected to the voting of Mrs. Haley's stock in any manner other than in accordance with Mr. Loos' direction. The chairman ruled that the stock could not be voted contrary to such direction, and declared the motion for adjournment had carried. Nevertheless, the meeting proceeded to the election of directors. Mrs. Ringling stated that she would continue in the meeting "but without prejudice to her position with respect to the voting of the stock and the fact that adjournment had not been taken." Mr. Loos directed Mrs. Ringling to cast her votes

882 for Mrs. Ringling,

882 for her son, Robert, and

441 for a Mr. Dunn,

who had been a member of the board for several years. She complied. Mr. Loos directed that Mrs. Haley's votes be cast

882 for Mrs. Haley,

882 for Mr. Haley, and

441 for Mr. Dunn.

Instead of complying, Mr. Haley attempted to vote his wife's shares

1103 for Mrs. Haley, and

1102 for Mr. Haley.

Mr. North voted his shares

864 for a Mr. Woods,

863 for a Mr. Griffin, and

863 for Mr. North.

The chairman ruled that the five candidates proposed by Mr. Loos, together with Messrs. Woods and North, were elected. The Haley-North group disputed this ruling insofar as it declared the election of Mr. Dunn; and insisted that Mr. Griffin, instead, had been elected. A directors' meeting followed in which Mrs. Ringling participated after stating that she would do so "without prejudice to her position that the stockholders' meeting had been adjourned and that the directors' meeting was not properly held." Mr. Dunn and Mr. Griffin, although each was challenged by an opposing faction, attempted to join in voting as directors for

different slates of officers. Soon after the meeting, Mrs. Ringling instituted this proceeding.

The Vice Chancellor determined that the agreement to vote in accordance with the direction of Mr. Loos was valid as a "stock pooling agreement" with lawful objects and purposes, and that it was not in violation of any public policy of this state. He held that where the arbitrator acts under the agreement and one party refuses to comply with his direction, "the Agreement constitutes the willing party . . . an implied agent possessing the irrevocable proxy of the recalcitrant party for the purpose of casting the particular vote." It was ordered that a new election be held before a master, with the direction that the master should recognize and give effect to the agreement if its terms were properly invoked.

Before taking up defendants' objections to the agreement, let us analyze particularly what it attempts to provide with respect to voting, including what functions and powers it attempts to repose in Mr. Loos, the "arbitrator." The agreement recites that the parties desired "to continue to act jointly in all matters relating to their stock ownership or interest in" the corporation. The parties agreed to consult and confer with each other in exercising their voting rights and to act jointly—that is, concertedly; unitedly; towards unified courses of action—in accordance with such agreement as they might reach. Thus, so long as the parties agree for whom or for what their shares shall be voted, the agreement provides no function for the arbitrator. His role is limited to situations where the parties fail to agree upon a course of action. In such cases, the agreement directs that "the question in disagreement shall be submitted for arbitration" to Mr. Loos "as arbitrator and his decision thereon shall be binding upon the parties." These provisions are designed to operate in aid of what appears to be a primary purpose of the parties, "to act jointly" in exercising their voting rights, by providing a means for fixing a course of action whenever they themselves might reach a stalemate.

Should the agreement be interpreted as attempting to empower the arbitrator to carry his directions into effect? Certainly there is no express delegation or grant of power to do so, either by authorizing him to vote the shares or to compel either party to vote them in accordance with his directions. The agreement expresses no other function of the arbitrator than that of deciding questions in disagreement which prevent the effectuation of the purpose "to act jointly." The power to enforce a decision does not seem a necessary or usual incident of such a function. Mr. Loos is not a party to the agreement. It does not contemplate the transfer of any shares or interest in shares to him, or that he should undertake any duties which the parties might compel him to perform. They provided that they might designate any other individual to act instead of Mr. Loos. The agreement does not attempt to make the arbitrator a trustee of an express trust. What the arbitrator is to do is for the benefit of the parties, not for his own benefit. Whether the parties accept or reject his decision

is no concern of his, so far as the agreement or the surrounding circumstances reveal. We think the parties sought to bind each other, but to be bound only to each other, and not to empower the arbitrator to enforce decisions he might make.

From this conclusion, it follows necessarily that no decision of the arbitrator could ever be enforced if both parties to the agreement were unwilling that it be enforced, for the obvious reason that there would be no one to enforce it. Under the agreement, something more is required after the arbitrator has given his decision in order that it should become compulsory: at least one of the parties must determine that such decision shall be carried into effect. Thus, any "control" of the voting of the shares, which is reposed in the arbitrator, is substantially limited in action under the agreement in that it is subject to the overriding power of the parties themselves.

The agreement does not describe the undertaking of each party with respect to a decision of the arbitrator other than to provide that it "shall be binding upon the parties." It seems to us that this language, considered with relation to its context and the situations to which it is applicable, means that each party promised the other to exercise her own voting rights in accordance with the arbitrator's decision. The agreement is silent about any exercise of the voting rights of one party by the other. The language with reference to situations where the parties arrive at an understanding as to voting plainly suggests "action" by each, and "exercising" voting rights by each, rather than by one for the other. There is no intimation that this method should be different where the arbitrator's decision is to be carried into effect. Assuming that a power in each party to exercise the voting rights of the other might be a relatively more effective or convenient means of enforcing a decision of the arbitrator than would be available without the power, this would not justify implying a delegation of the power in the absence of some indication that the parties bargained for that means. The method of voting actually employed by the parties tends to show that they did not construe the agreement as creating powers to vote each other's shares; for at meetings prior to 1946 each party apparently exercised her own voting rights, and at the 1946 meeting, Mrs. Ringling, who wished to enforce the agreement, did not attempt to cast a ballot in exercise of any voting rights of Mrs. Haley. We do not find enough in the agreement or in the circumstances to justify a construction that either party was empowered to exercise voting rights of the other.

Having examined what the parties sought to provide by the agreement, we come now to defendants' contention that the voting provisions are illegal and revocable. They say that the courts of this state have definitely established the doctrine "that there can be no agreement, or any device whatsoever, by which the voting power of stock of a Delaware corporation may be irrevocably separated from the ownership of the stock, except by an agreement which complies with Section 18" of

the Corporation Law, Rev.Code 1935, § 2050, and except by a proxy coupled with an interest. . . . The statute reads, in part, as follows:

"Sec. 18. Fiduciary Stockholders; Voting Power of; Voting Trusts:— Persons holding stock in a fiduciary capacity shall be entitled to vote the shares so held, and persons whose stock is pledged shall be entitled to vote, unless in the transfer by the pledgor on the books of the corporation he shall have expressly empowered the pledgee to vote thereon, in which case only the pledgee, or his proxy may represent said stock and vote thereon.

"One or more stockholders may by agreement in writing deposit capital stock of an original issue with or transfer capital stock to any person or persons, or corporation or corporations authorized to act as trustee, for the purpose of vesting in said person or persons, corporation or corporations, who may be designated Voting Trustee or Voting Trustees, the right to vote thereon for any period of time determined by such agreement, not exceeding ten years, upon the terms and conditions stated in such agreement. Such agreement may contain any other lawful provisions not inconsistent with said purpose. . . . Said Voting Trustees may vote upon the stock so issued or transferred during the period in such agreement specified; stock standing in the names of such Voting Trustees may be voted either in person or by proxy, and in voting said stock, such Voting Trustees shall incur no responsibility as stockholder, trustee or otherwise, except for their own individual malfeasance."²

In our view, neither the cases nor the statute sustain the rule for which the defendants contend. Their sweeping formulation would impugn well-recognized means by which a shareholder may effectively confer his voting rights upon others while retaining various other rights. For example, defendants' rule would apparently not permit holders of voting stock to confer upon stockholders of another class, by the device of an amendment of the certificate of incorporation, the exclusive right to vote during periods when dividends are not paid on stock of the latter class. The broad prohibitory meaning which defendants find in Section 18 seems inconsistent with their concession that proxies coupled with an interest may be irrevocable, for the statute contains nothing about such proxies. The statute authorizes, among other things, the deposit or transfer of stock in trust for a specified purpose, namely, "vesting" in the transferee "the right to vote thereon" for a limited period; and prescribes numerous requirements in this connection. Accordingly, it seems reasonable to infer that to establish the relationship and accomplish the purpose which the statute authorizes, its requirements must be complied with. But the statute does not purport to deal with agreements whereby shareholders attempt to bind each other as to how they shall vote their

² Omitted portions of the section provide requirements for the filing of a copy of the agreement in the principal Delaware office of the corporation for the issuance of certificates of stock to the voting trustees, for the voting of stock where there are more than one voting trustee, and for the extension of the agreement for additional periods, not exceeding ten years each.

shares. Various forms of such pooling agreements, as they are sometimes called, have been held valid and have been distinguished from voting trusts. . . . We think the particular agreement before us does not violate Section 18 or constitute an attempted evasion of its requirements, and is not illegal for any other reason. Generally speaking, a shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed his fellow shareholders. . . . The ownership of voting stock imposes no legal duty to vote at all. A group of shareholders may, without impropriety, vote their respective shares so as to obtain advantages of concerted action. They may lawfully contract with each other to vote in the future in such way as they, or a majority of their group, from time to time determine. . . . Reasonable provisions for cases of failure of the group to reach a determination because of an even division in their ranks seem unobjectionable. The provision here for submission to the arbitrator is plainly designed as a deadlock-breaking measure, and the arbitrator's decision cannot be enforced unless at least one of the parties (entitled to cast one-half of their combined votes) is willing that it be enforced. We find the provision reasonable. It does not appear that the agreement enables the parties to take any unlawful advantage of the outside shareholder, or of any other person. It offends no rule of law or public policy of this state of which we are aware.

Legal consideration for the promises of each party is supplied by the mutual promises of the other party. The undertaking to vote in accordance with the arbitrator's decision is a valid contract. The good faith of the arbitrator's action has not been challenged and, indeed, the record indicates that no such challenge could be supported. Accordingly, the failure of Mrs. Haley to exercise her voting rights in accordance with his decision was a breach of her contract. It is no extenuation of the breach that her votes were cast for two of the three candidates directed by the arbitrator. His directions to her were part of a single plan or course of action for the voting of the shares of both parties to the agreement, calculated to utilize an advantage of joint action by them which would bring about the election of an additional director. The actual voting of Mrs. Haley's shares frustrates that plan to such an extent that it should not be treated as a partial performance of her contract.

Throughout their argument, defendants make much of the fact that all votes cast at the meeting were by the registered shareholders. The Court of Chancery may, in a review of an election, reject votes of a registered shareholder where his voting of them is found to be in violation of rights of another person. . . . It seems to us that upon the application of Mrs. Ringling, the injured party, the votes representing Mrs. Haley's shares should not be counted. Since no infirmity in Mr. North's voting has been demonstrated, his right to recognition of what he did at the meeting should be considered in granting any relief to Mrs. Ringling; for

her rights arose under a contract to which Mr. North was not a party. With this in mind, we have concluded that the election should not be declared invalid, but that effect should be given to a rejection of the votes representing Mrs. Haley's shares. No other relief seems appropriate in this proceeding. Mr. North's vote against the motion for adjournment was sufficient to defeat it. With respect to the election of directors, the return of the inspectors should be corrected to show a rejection of Mrs. Haley's votes, and to declare the election of the six persons for whom Mr. North and Mrs. Ringling voted.

This leaves one vacancy in the directorate. The question of what to do about such a vacancy was not considered by the court below and has not been argued here. For this reason, and because an election of directors at the 1947 annual meeting (which presumably will be held in the near future) may make a determination of the question unimportant, we shall not decide it on this appeal. If a decision of the point appears important to the parties, any of them may apply to raise it in the Court of Chancery, after the mandate of this court is received there.

An order should be entered directing a modification of the order of the Court of Chancery in accordance with this opinion.

ANALYSIS

1. If you had been in the position of Loos, attorney for several years for Mrs. Ringling and Mrs. Haley, what would you have said when they asked you to act as arbitrator under their agreement?
2. Did Mrs. Haley win or lose?
3. Note that Mrs. Ringling did not seek specific performance. The suit she filed was to review an election. What would the result have been if she had sought specific performance?
4. How should the agreement have been drafted to make a lawsuit unnecessary?

McQuade v. Stoneham

263 N.Y. 323, 189 N.E. 234 (1934).

■ POUND, CHIEF JUDGE. The action is brought to compel specific performance of an agreement between the parties, entered into to secure the control of National Exhibition Company, also called the Baseball Club (New York Nationals or "Giants"). This was one of Stoneham's enterprises which used the New York polo grounds for its home games. McGraw was manager of the Giants. McQuade was at the time the contract was entered into a city magistrate. He resigned December 8, 1930.

Defendant Stoneham became the owner of 1,306 shares, or a majority of the stock of National Exhibition Company. Plaintiff and defendant McGraw each purchased 70 shares of his stock. Plaintiff paid

Stoneham \$50,338.10 for the stock he purchased. As a part of the transaction, the agreement in question was entered into. It was dated May 21, 1919. Some of its pertinent provisions are

"VIII. The parties hereto will use their best endeavors for the purpose of continuing as directors of said Company and as officers thereof the following:

"Directors:

"Charles A. Stoneham,

"John J. McGraw,

"Francis X. McQuade

"—with the right to the party of the first part [Stoneham] to name all additional directors as he sees fit:

"Officers:

"Charles A. Stoneham, President,

"John J. McGraw, Vice-President,

"Francis X. McQuade, Treasurer.

"IX. No salaries are to be paid to any of the above officers or directors, except as follows:

"President \$45,000

"Vice-President 7,500

"Treasurer 7,500

"X. There shall be no change in said salaries, no change in the amount of capital, or the number of shares, no change or amendment of the by-laws of the corporation or any matters regarding the policy of the business of the corporation or any matters which may in anywise affect, endanger or interfere with the rights of minority stockholders, excepting upon the mutual and unanimous consent of all of the parties hereto. . . .

"XIV. This agreement shall continue and remain in force so long as the parties or any of them or the representative of any, own the stock referred to in this agreement, to wit, the party of the first part, 1,166 shares, the party of the second part 70 shares and the party of the third part 70 shares, except as may otherwise appear by this agreement. . . ."

In pursuance of this contract Stoneham became president and McGraw vice president of the corporation. McQuade became treasurer. In June, 1925, his salary was increased to \$10,000 a year. He continued to act until May 2, 1928, when Leo J. Bondy was elected to succeed him. The board of directors consisted of seven men. The four outside of the parties hereto were selected by Stoneham and he had complete control over them. At the meeting of May 2, 1928, Stoneham and McGraw

refrained from voting, McQuade voted for himself, and the other four voted for Bondy. Defendants did not keep their agreement with McQuade to use their best efforts to continue him as treasurer. On the contrary, he was dropped with their entire acquiescence. At the next stockholders' meeting he was dropped as a director although they might have elected him.

The courts below have refused to order the reinstatement of McQuade, but have given him damages for wrongful discharge, with a right to sue for future damages.

The cause for dropping McQuade was due to the falling out of friends. McQuade and Stoneham had disagreed. The trial court has found in substance that their numerous quarrels and disputes did not affect the orderly and efficient administration of the business of the corporation; that plaintiff was removed because he had antagonized the dominant Stoneham by persisting in challenging his power over the corporate treasury and for no misconduct on his part. The court also finds that plaintiff was removed by Stoneham for protecting the corporation and its minority stockholders. We will assume that Stoneham put him out when he might have retained him, merely in order to get rid of him.

Defendants say that the contract in suit was void because the directors held their office charged with the duty to act for the corporation according to their best judgment and that any contract which compels a director to vote to keep any particular person in office and at a stated salary is illegal. Directors are the exclusive executive representatives of the corporation, charged with administration of its internal affairs and the management and use of its assets. They manage the business of the corporation. (General Corporation Law, Consol. Laws, c. 23, § 27.) "An agreement to continue a man as president is dependent upon his continued loyalty to the interests of the corporation." *Fells v. Katz*, 256 N.Y. 67, 72, 175 N.E. 516, 517. So much is undisputed.

Plaintiff contends that the converse of this proposition is true and that an agreement among directors to continue a man as an officer of a corporation is not to be broken so long as such officer is loyal to the interests of the corporation and that, as plaintiff has been found loyal to the corporation, the agreement of defendants is enforceable.

Although it has been held that an agreement among stockholders whereby it is attempted to divest the directors of their power to discharge an unfaithful employee of the corporation is illegal as against public policy (*Fells v. Katz*, *supra*), it must be equally true that the stockholders may not, by agreement among themselves, control the directors in the exercise of the judgment vested in them by virtue of their office to elect officers and fix salaries. Their motives may not be questioned so long as their acts are legal. The bad faith or the improper motives of the parties does not change the rule. . . . Directors may not by agreements entered into as stockholders abrogate their independent judgment. . . .

Stockholders may, of course, combine to elect directors. That rule is well settled. As Holmes, C.J., pointedly said (*Brightman v. Bates*, 175 Mass. 105, 111, 55 N.E. 809, 811): "If stockholders want to make their power felt, they must unite. There is no reason why a majority should not agree to keep together." The power to unite is, however, limited to the election of directors and is not extended to contracts whereby limitations are placed on the power of directors to manage the business of the corporation by the selection of agents at defined salaries.

The minority shareholders whose interests McQuade says he has been punished for protecting, are not, aside from himself, complaining about his discharge. He is not acting for the corporation or for them in this action. It is impossible to see how the corporation has been injured by the substitution of Bondy as treasurer in place of McQuade. As McQuade represents himself in this action and seeks redress for his own wrongs, "we prefer to listen to [the corporation and the minority stockholders] before any decision as to their wrongs." *Faulds v. Yates*, 57 Ill. 416, 417, 11 Am.Rep. 24.

It is urged that we should pay heed to the morals and manners of the market place to sustain this agreement and that we should hold that its violation gives rise to a cause of action for damages rather than base our decision on any outworn notions of public policy. Public policy is a dangerous guide in determining the validity of a contract and courts should not interfere lightly with the freedom of competent parties to make their own contracts. We do not close our eyes to the fact that such agreements, tacitly or openly arrived at, are not uncommon, especially in close corporations where the stockholders are doing business for convenience under a corporate organization. We know that majority stockholders, united in voting trusts, effectively manage the business of a corporation by choosing trustworthy directors to reflect their policies in the corporate management. Nor are we unmindful that McQuade has, so the court has found, been shabbily treated as a purchaser of stock from Stoneham. We have said: "A trustee is held to something stricter than the morals of the market place" (*Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546), but Stoneham and McGraw were not trustees for McQuade as an individual. Their duty was to the corporation and its stockholders, to be exercised according to their unrestricted lawful judgment. They were under no legal obligation to deal righteously with McQuade if it was against public policy to do so.

The courts do not enforce mere moral obligations, nor legal ones either, unless someone seeks to establish rights which may be waived by custom and for convenience. We are constrained by authority to hold that a contract is illegal and void so far as it precludes the board of directors, at the risk of incurring legal liability, from changing officers, salaries, or policies or retaining individuals in office, except by consent of the contracting parties. On the whole, such a holding is probably preferable

to one which would open the courts to pass on the motives of directors in the lawful exercise of their trust.

A further reason for reversal exists. At the time the contract was made the plaintiff was a city magistrate. . . .

The Inferior Criminal Courts Act (Laws of 1910, c. 659, as amended) provides that no "city magistrate shall engage in any other business, profession or hold any other public office or shall serve as the representative of any political party for any assembly, aldermanic, senatorial or congressional district in the executive committee or other governing body of any political party organization or political party association. No city magistrate shall engage in any other business or profession or act as referee, or receiver, but each of said justices and magistrates shall devote his whole time and capacity, so far as the public interest demands, to the duties of his office. . . ." (Section 161, Laws 1933, c. 746, formerly section 102, as amended, Laws 1915, c. 531.) The contract contemplated that the plaintiff should hold an executive office at a stipulated and substantial salary. . . .

Until the date when the defendant repudiated the agreement, its performance constituted a violation of the statute. . . .

■ LEHMAN, JUDGE.

I concur in the decision of the court on the second ground stated in the opinion. I desire to state the reasons why I do not accept the first ground.

. . .

We have said: "An ordinary agreement, among a minority in number, but a majority in shares, for the purpose of obtaining control of the corporation by the election of particular persons as directors is not illegal." *Manson v. Curtis*, 223 N.Y. 313, 319, 119 N.E. 559, 561, Ann.Cas. 1918E, 247. We are agreed that, if the contract had provided only for the election of directors, it would not have been illegal. Its vice, if any, is inherent in the provisions intended to give assurance that the directors so elected would act according to the prearranged design of the stockholders in apportioning the corporate offices and emoluments of such offices among the majority stockholders.

. . .

There can, I think, be no doubt that shareholders owning a majority of the corporate stock may combine to obtain and exercise any control which a single owner of such stock could exercise. What may lawfully be done by an individual may ordinarily be lawfully done by a combination, but no combination is legal if formed to accomplish an illegal object. No such combination or agreement may "contravene any express charter or statutory provision or contemplate any fraud, oppression or wrong against other stockholders or other illegal object." *Manson v. Curtis*, *supra*.

In that case we held invalid, on that ground, an agreement for the selection "of directors who should remain passive or mechanical to the will and word" of one of the parties to the agreement. Now it is said that, for the same reason, this agreement must be held unenforceable, though here the agreement contemplated no restriction upon the powers of the board of directors, and no dictation or interference by stockholders except in so far as concerns the election and remuneration of officers and the adherence by the corporation to established policies.

It seems difficult to reconcile such a decision with the statements in the opinion in *Manson v. Curtis* that "it is not illegal or against public policy for two or more stockholders owning the majority of the shares of stock to unite upon a course of corporate policy or action, or upon the officers whom they will elect," and that "shareholders have the right to combine their interests and voting powers to secure such control of the corporation and the adoption of and adherence by it to a specific policy and course of business." Obviously, a combination intended to effect the election of certain officers and to obtain control of the corporation and adherence by it to a specific policy and course of business can accomplish its ends only to the extent that directors will bow to the will of those who united to elect them. The directors have the power and the duty to act in accordance with their own best judgment so long as they remain directors. The majority stockholders can compel no action by the directors, but at the expiration of the term of office of the directors the stockholders have the power to replace them with others whose actions coincide with the judgment or desires of the holders of a majority of the stock. The theory that directors exercise in all matters an independent judgment in practice often yields to the fact that the choice of directors lies with the majority stockholders and thus gives the stockholders a very effective control of the action by the board of directors. In truth the board of directors may check the arbitrary will of those who would otherwise completely control the corporation, but cannot indefinitely thwart their will.

A contract which destroys this check contravenes "express charter or statutory provisions" and is, therefore, illegal. A contract which merely provides that stockholders shall in combination use their power to achieve a legitimate purpose is not illegal. They may join in the election of directors who, in their opinion, will be in sympathy with the policies of the majority stockholders and who, in the choice of executive officers, will be influenced by the wishes of the majority stockholders. The directors so chosen may not act in disregard of the best interests of the corporation and its minority stockholders, but with that limitation they may and, in practice, usually are swayed by the wishes of the majority. Otherwise there would be no continuity of corporate policy and no continuity in management of corporate affairs.

The contract now under consideration provides, in a narrow field, for corporate action within these limitations. . . . A contract which merely

provides for the election of fit officers and adhesion to particular policy determined in advance constitutes an agreement by which men in combination exercise a power which could be lawfully exercised if lodged in a single man. It is legal, if designed to protect legitimate interests without wrong to others. Public policy should be governed by facts, not abstractions. The contract is, in my opinion, valid. It is unenforceable only because it resulted in an employment which was itself illegal.

- CRANE, KELLOGG, O'BRIEN, and HUBBS, JJ., concur with POUND, C.J.
- LEHMAN, J., concurs in result in opinion in which CROUCH, J., concurs.

Clark v. Dodge

269 N.Y. 410, 199 N.E. 641 (1936).

...

The two corporate defendants are New Jersey corporations manufacturing medicinal preparations by secret formulae. The main office, factory, and assets of both corporations are located in the state of New York. In 1921, and at all times since, Clark owned 25 per cent. and Dodge 75 per cent. of the stock of each corporation. Dodge took no active part in the business, although he was a director, and through ownership of their qualifying shares, controlled the other directors of both corporations. He was the president of Bell & Co., Inc., and nominally general manager of Hollings-Smith Company, Inc. The plaintiff, Clark, was a director and held the offices of treasurer and general manager of Bell & Co., Inc., and also had charge of the major portion of the business of Hollings-Smith Company, Inc. The formulae and methods of manufacture of the medicinal preparations were known to him alone. Under date of February 15, 1921, Dodge and Clark, the sole owners of the stock of both corporations, entered into a written agreement under seal, which after reciting the stock ownership of both parties, the desire of Dodge that Clark should continue in the efficient management and control of the business of Bell & Co., Inc., so long as he should "remain faithful, efficient and competent to so manage and control the said business"; and his further desire that Clark should not be the sole custodian of a specified formula, but should share his knowledge thereof and of the method of manufacture with a son of Dodge, provided, in substance, as follows: That Dodge during his lifetime and, after his death, a trustee to be appointed by his will, would so vote his stock and so vote as a director that the plaintiff (a) should continue to be a director of Bell & Co., Inc.; and (b) should continue as its general manager so long as he should be "faithful, efficient and competent"; (c) should during his life receive one-fourth of the net income of the corporations either by way of salary or dividends; and (d) that no unreasonable or incommensurate salaries should be paid to other officers or agents which would so reduce the net income as materially to affect Clark's profits. Clark on his part agreed to disclose the specified formula to the son and to instruct him in

the details and methods of manufacture; and, further, at the end of his life to bequeath his stock—if no issue survived him—to the wife and children of Dodge.

It was further provided that the provisions in regard to the division of net profits and the regulation of salaries should also apply to the Hollings-Smith Company.

The complaint alleges due performance of the contract by Clark and breach thereof by Dodge in that he has failed to use his stock control to continue Clark as a director and as general manager, and has prevented Clark from receiving his proportion of the income, while taking his own, by causing the employment of incompetent persons at excessive salaries, and otherwise.

The relief sought is reinstatement as director and general manager and an accounting by Dodge and by the corporations for waste and for the proportion of net income due plaintiff, with an injunction against further violations.

The only question which need be discussed is whether the contract is illegal as against public policy within the decision in *McQuade v. Stoneham*, 263 N.Y. 323, 189 N.E. 234, upon the authority of which the complaint was dismissed by the Appellate Division.

"The business of a corporation shall be managed by its board of directors." General Corporation Law (Consol.Laws, c. 23) § 27. That is the statutory norm. Are we committed by the *McQuade* Case to the doctrine that there may be no variation, however slight or innocuous, from that norm, where salaries or policies or the retention of individuals in office are concerned? There is ample authority supporting that doctrine, . . . and something may be said for it, since it furnishes a simple, if arbitrary, test. Apart from its practical administrative convenience, the reasons upon which it is said to rest are more or less nebulous. Public policy, the intention of the Legislature, detriment to the corporation, are phrases which in this connection mean little. Possible harm to bona fide purchasers of stock or to creditors or to stockholding minorities have more substance; but such harms are absent in many instances. If the enforcement of a particular contract damages nobody—not even, in any perceptible degree, the public—one sees no reason for holding it illegal, even though it impinges slightly upon the broad provision of section 27. Damage suffered or threatened is a logical and practical test, and has come to be the one generally adopted by the courts. . . . Where the directors are the sole stockholders, there seems to be no objection to enforcing an agreement among them to vote for certain people as officers. There is no direct decision to that effect in this court, yet there are strong indications that such a rule has long been recognized. The opinion in *Manson v. Curtis*, 223 N.Y. 313, 325, 119 N.E. 559, 562, Ann.Cas. 1918E, 247, closed its discussion by saying: "The rule that all the stockholders by their universal consent may do as they choose with the corporate concerns and assets, provided the interests of creditors are not affected,