The attached article, Corporate Governance Update: The Unintended Consequences of Proxy Access Elections, was published in the New York Law Journal on March 26, 2015

March 26, 2015

Corporate Governance Update: The Unintended Consequences of Proxy Access Elections

David A. Katz
and
Laura A. McIntosh*

It's official: Proxy access is the darling of the 2015 season. Shareholder-sponsored proxy access proposals are on the ballots of more than 100 U.S. public companies this spring.[1] These precatory proposals seek a shareholder vote on a binding bylaw that would enable shareholders who meet certain ownership requirements to nominate board candidates and have them included in the company's own proxy materials. Powerful institutional investors have given the proxy access movement enormous momentum this spring,[2] and blue chip firms such as GE,[3] Bank of America,[4] and Prudential[5] have voluntarily adopted versions of proxy access in advance of their annual meetings. Companies such as Citigroup[6] have agreed to support proxy access shareholder proposals in their definitive proxy materials. In the absence of regulatory guidance, proxy advisors such as ISS have stepped into the breach to define the terms and conditions of proxy access.[7] As proxy access proposals proliferate—after years of

---

* David A. Katz is a partner at Wachtell, Lipton, Rosen & Katz. Laura A. McIntosh is a consulting attorney for the firm. The views expressed are the authors' and do not necessarily represent the views of the partners of Wachtell, Lipton, Rosen & Katz or the firm as a whole.

[1] *See* Andrew Ackerman & Joann S. Lublin, "In Shift, Firms Give Investors New Clout Over Board Seats," Wall St. J., March 16, 2015, available at www.wsj.com/articles/in-shift-firms-give-investors-new-clout-over-board-seats-1426550134.

[2] *See, e.g.*, Reuters, "Exclusive: TIAA-CREF Joins 'Proxy Access' Push With Letter to Top Holdings," March 12, 2015, available at www.reuters.com/article/2015/03/12/us-shareholder-elections-tiaa-cref-exclu-idUSKBN0M825220150312; Press Release, NYC Comptroller, "Comptroller Stringer, NYC Pension Funds Launch National Campaign To Give Shareholders a True Voice in How Corporate Boards Are Elected," Nov. 6, 2014, available at comptroller.nyc.gov/newsroom/comptroller-stringer-nyc-pension-funds-launch-national-campaign-to-give-shareowners-a-true-voice-in-how-corporate-boards-are-elected/.

[3] *See* General Electric Current Report on Form 8-K dated Feb. 6, 2015, available at www.ge.com/investor-relations/shareholder-services/personal-investing/sec-filing/general-electric-company.

[4] *See* Bank of America Current Report on Form 8-K dated March 20, 2015, available at www.sec.gov/Archives/edgar/data/70858/000007085815000026/0000070858-15-000026-index.htm.

[5] *See* Prudential Current Report on Form 8-K dated March 10, 2015, available at www.investor.prudential.com/phoenix.zhtml?c=129695&p=irol-sec&secCat01.3_rs=11&secCat01.3_rc=10&control_selectgroup=Show%20All.

[6] *See* Citigroup Annual Meeting Proxy Statement dated March 18, 2015, available at www.sec.gov/Archives/edgar/data/831001/000120677415000923/0001206774-15-000923-index.htm.

[7] *See, e.g.*, Institutional Shareholder Services, "2015 Benchmark U.S. Proxy Voting Policies—Frequently Asked Questions on Selected Topics," Feb. 29, 2015, available at www.issgovernance.com; Patrick McGurn & Edward Kamonjoh, "Proxy Access in the U.S.—What To Expect for the 2015 Proxy Season," ISS Publication, Feb. 23, 2015, available at www.issgovernance.com.

controversy[8]—the primary debate now seems to be whether a 3 percent or 5 percent ownership threshold is more appropriate.[9]

All this is not to say that proxy access is a *fait accompli*, and its current popularity among shareholders certainly does not mean that it is the right choice for American corporations.[10] It is very much an open question whether proxy access will become an established part of U.S. corporate governance. Interestingly, despite all the ballot-box excitement, there has been little discussion of what shareholders could expect if proxy access were to become widely adopted and—as is the stated goal—directors proposed by a shareholder were then elected.[11] In fact, it is likely that "proxy access directors" would find themselves in an unenviable position, facing conflicts and conundrums that many proponents of proxy access do not appear to have fully considered.

Proxy access directors, by analogy to "constituency" or "blockholder" directors, would, on the one hand, be required to fulfill their legal duties and fiduciary obligations to all shareholders. On the other hand, they would be seen as owing allegiance to one or more shareholders in particular—shareholders whose agendas were compelling enough, and different enough from the company's current strategy and direction, for them to seek their own board seats using the company's own proxy statement. As major shareholders frequently collaborate in private (as permitted by an exemption to the proxy solicitation requirements[12]), the identities and goals of a proxy access director's supporters would not necessarily be publicly known. Because of this lack of transparency, the role of a proxy access director would be even less well understood than that of the typical constituency director. We believe that this situation would be rife with potential pitfalls for the director, for the board, and for the company and its shareholders.

---

[8] The Securities and Exchange Commission (SEC) proposed proxy access rules in 2003 and 2007 and adopted a final rule in 2010 pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. SEC Rel. Nos. 33-9136; 34-62764, Nov. 15, 2010, available at www.sec.gov/rules/final/2010/33-9136.pdf. The rule was vacated by the U.S. Court of Appeals for the District of Columbia Circuit in July of 2011 before it became effective. *See* Business Roundtable and Chamber of Commerce v. Securities and Exchange Commission, No. 10-1305 (D.C. Cir. July 22, 2010). The SEC has permitted shareholder proposals on proxy access under Rule 14a-8 since September of 2011. SEC Rel. Nos. 33-9259; 34-65343, Sept. 15, 2011, available at www.sec.gov/rules/final/2011/33-9259.pdf.

[9] *See* Gretchen Morgenson, "In Whole Foods Backlash, a Chance To Air Out Stagnant Boardrooms," N.Y. Times, Feb. 21, 2015, available at nyti.ms/1D1e9jj.

[10] *See, e.g.*, David F. Larcker et al., "The Market Reaction to Corporate Governance," May 3, 2010, at 4 ("[W]e find strong evidence …. consistent with critics' claims that proxy access regulations … increase the power of blockholders that may not act in the interest of other shareholders…."), available at www.sciencedirect.com/science/article/pii/S0304405X11000675 (subscription required).

[11] We are not aware of any U.S. public company director that has been elected via proxy access to date.

[12] Rule 14a-2(b)(2) under the Securities Exchange Act of 1934, as amended; *see also* The Activist Investor, "Exempt Proxy Solicitations," available at www.theactivistinvestor.com/The_Activist_Investor/Exempt_Solicitations.html.

Constituency Directors

"Constituency directors" are those whose election to the board is due to a special relationship between the company and a particular entity or group.[13] Common examples of constituency directors on public company boards include parent company executives or directors, representatives of unions or creditors, designees of classes of preferred shares, winners of short-slate proxy contests run by hedge funds or other activists, or private-investment-in-public-equity (PIPE) transaction appointees. In some cases, private companies that become public may continue to have directors who represent ongoing private equity or venture capital investments, or original founding family members representing significant ownership of the company. The term "blockholder directors" is generally used to indicate the subset of constituency directors whose board membership is due to a particular class of stock or to an insurgent group of shareholders.[14]

A constituency director is intended to represent the interests of a particular group or entity on the board. The director may be expected to, among other things, advocate for certain positions advantageous to the sponsor (in which case the director's relationship with the sponsor should be fully disclosed to the board and shareholders),[15] relay information to the sponsor (in which case the board should ensure that the sponsor is required to keep the information confidential),[16] or focus on aspects of oversight that are of particular interest to the sponsor. Regardless of a constituency director's arrangement with his or her sponsor, Delaware law is very clear: Every director owes fiduciary duties to *all* the shareholders of a company. A constituency director has neither the right nor the obligation to favor a sponsor over the other shareholders.[17] Articulating a (fully disclosed) sponsor's viewpoint in a board meeting is on one side of the line; voting against the interests of shareholders other than the sponsor is on the other. Indeed, blockholder directors run significant risks regarding losing the protections of the

---

[13] *See* Joseph Hinsey, "The Constituency Director," Jan. 14, 2008, available at blogs.law.harvard.edu/corpgov/2008/01/14/the-constituency-director/.

[14] *See* J. Travis Laster & John Mark Zeberkiewicz, "The Rights and Duties of Blockholder Directors," Business Lawyer, Vol. 70, Winter 2014/2015, available at www.americanbar.org/tools/digitalassetabstract.html/content/dam/aba/publications/business_lawyer/2015/70_1/article-blockholder-directors-201501.pdf (subscription required).

[15] *See* E. Norman Veasey & Christine T. Di Guglielmo, "How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors," Business Lawyer, Vol. 63, May 2008, at 772, available at www.americanbar.org/tools/digitalassetabstract.html/content/dam/aba/publications/business_lawyer/2008/63_3/article-constituency-directors-200805.pdf (subscription required).

[16] *See* Laster & Zeberkiewicz, *supra*, at 56.

[17] *See, e.g.*, Klaassen v. Allegro Dev. Corp., Civ. A. No. 8626-VCL, 2013 WL 5967028, at *11 (Del. Ch. Nov. 7, 2013) ("[C]orporate directors do not owe fiduciary duties to individual stockholders; they owe fiduciary duties to the entity and to the stockholders as a whole." (citations omitted)); Phillips v. Insituform of N. Am., Civ. A. No. 9173, 1987 WL 16285, at *10 (Del. Ch. Aug. 27, 1987) ("[T]he law demands of directors … fidelity to the corporation and all of its shareholders and does not recognize a special duty on the part of directors elected by a special class to the class electing them.").

business judgment rule if they act for the benefit of their sponsors and to the detriment of the other shareholders.[18]

The position of a constituency director can be precarious from a practical as well as a legal standpoint. It is not uncommon for constituency directors to be board outsiders, distrusted and isolated to varying degrees. The board frequently views a constituency director as an adversary, or at least as the eyes and ears of the sponsor, and thus other directors may be unwilling to engage in open discourse on strategic or other sensitive matters in his or her presence. In extreme cases, official board meetings can become *pro forma* affairs, while the real business of the board is conducted either off the record or in special committees formed for the purpose of excluding the constituency director. The legality of these tactics may fall into a fact-dependent gray area,[19] but in practical terms, effective isolation is very difficult for an excluded director to overcome. By the same token, it is often a mistake for a board to isolate a constituency director who is actually truly independent of the constituency that promoted their election.

A recent article by Vice Chancellor Travis Laster of Delaware and Delaware lawyer John Mark Zeberkiewicz discusses the rights and duties of blockholder directors under Delaware law and concludes that care must be taken on both sides: Boards must recognize the rights of blockholder directors to participate fully in board decision-making, absent a conflict of interest with respect to a specific situation, while at the same time blockholder directors must be diligent in fulfilling their duties to all shareholders equally and should recognize that the position of representing particular constituencies may make them vulnerable to claims of breach of their duty of loyalty.[20]

One such claim arose in the 2013 case *In re Trados*, in which Vice Chancellor Laster found that directors representing venture capitalist holders of the company's preferred stock had a conflict of interest in a sale transaction and therefore applied the entire fairness standard of review.[21] While in *Trados* the court concluded that the transaction was substantively (though not procedurally) fair to all shareholders and thus found that the blockholder directors had not breached their fiduciary duties, this conclusion was based on a highly fact-specific analysis. Well-advised public company boards do their best to minimize the risk of having transactions reviewed under the elevated standard of entire fairness, and *Trados* is a reminder to boards with blockholder directors (as well as to individual blockholder directors) to be alert to potential conflicts.

---

[18] *See* Laster & Zeberkiewicz, *supra*, at 51.

[19] *See, e.g., id.* at 60 ("[T]he ability of a board majority to exclude minority directors stands in tension with the concepts of director involvement and collective deliberation…. At some point, if the use of a committee appears abusive, a court of equity is likely to step in. Where that line is drawn will depend heavily on the facts of the case that presents the issue.").

[20] *Id.*

[21] *In re* Trados S'holder Litig., 73 A.3d 17 (Del. Ch. 2013).

Boards with constituency or blockholder directors also must contend with the different investment horizons that may be represented by these directors. Venture capital investors, hedge fund activists and others are generally known for seeking short-term profits, often at the expense of a company's long-term prospects. While directors in Delaware are expected to use their business judgment to determine the appropriate time horizons for their decision-making, Vice Chancellor Laster has indicated that a director representing a short-term investor may have an inherent conflict: "A blockholder director who also serves in a fiduciary capacity for [a short-term] investor can face a conflict of interest: The blockholder director's duties to the corporation require that the director manage for the long term, while the blockholder director's duties to the investor require that the director manage for an exit."[22] It is this conflict that, they say, "poses serious risk because it creates exposure to a claim for a loyalty breach."[23] The argument that some blockholder directors necessarily face an inherent conflict may not be the predominant view at the moment,[24] but nonetheless it is a point that boards with blockholder directors should not dismiss lightly.

The issues created by having blockholder directors on a board are numerous and difficult. Having such directors elected to the board through proxy access adds another layer of complexity to what often is already a delicate situation.

Proxy Access Directors

Proponents of proxy access frequently speak in terms of "shareholder representation"[25] and "democracy."[26] These buzzwords are intended to appeal to the American understanding of political fairness. However, this metaphor fundamentally misunderstands the nature of a corporate board. In the United States, a public company board is not designed to be a representative democracy in which different directors speak for particular interest groups. Widespread utilization of proxy access could produce a system in which various factions nominate their candidates and the result could be an unpredictable array of representatives all owing allegiance to their individual sponsors. Such a situation could easily produce a dysfunctional board riven by divisive deadlocks and incapable of making decisions or providing effective oversight. American business owes much of its success to the current fiduciary model, in which the full board is required to use its collective business judgment to benefit the

---

[22] *See* Laster & Zeberkiewicz, *supra*, at 50.

[23] *Id.*

[24] *See* Jack Bodner, "Vice Chancellor Laster and the Long-Term Rule," March 11, 2015, available at blogs.law.harvard.edu/corpgov/2015/03/11/vice-chancellor-laster-and-the-long-term-rule/.

[25] *See, e.g.*, Bob McCormick, Glass, Lewis & Co., "Glass Lewis' Views on Proxy Access Developments," Jan. 28, 2015 (stating that Glass Lewis believes that shareholders should be allowed "to nominate a meaningful percentage of directors to adequately represent them"), available at www.glasslewis.com/blog/glass-lewis-views-proxy-access-developments/.

[26] *See, e.g.*, Robert Pozen, "Shareholders Get a Louder Voice as Companies Become More Democratic," March 3, 2015, available at www.realclearmarkets.com/articles/2015/03/03/shareholders_get_a_louder_voice_as_companies_become_more_democratic_101554.html.

corporation and its shareholders on an ongoing basis. This structure enables boards to maximize the value of the corporation over the long term.

Significant shareholders or shareholder groups that nominate a director through proxy access would expect the director to promote their interests at the board level. If they did not see a particular benefit to nominating their own candidate, after all, it would hardly be worth the effort. However, if proxy access directors do not act for the benefit of *all* shareholders, they will breach their fiduciary duties—thus potentially giving rise to legal challenges from other shareholders (or even directors), subjecting transactions to elevated review, and even, potentially, forfeiting the protection of the business judgment rule—and likely will find themselves isolated from board deliberations and discussions by the other directors. In such circumstances, proxy access directors may be unable to further the goals of their nominating shareholders; moreover, their presence could be detrimental to the company and all of its shareholders.

There is precedent in Delaware for challenging the loyalty of disinterested, outside directors. In a 2011 case, the Court of Chancery refused to dismiss a claim of breach of loyalty in a going-private transaction because it concluded that the outside directors—though they themselves had no financial conflicts, and despite the fact that all shareholders were treated equally in the transaction—possibly had been intimidated and harassed by the former chief executive to approve a transaction for his benefit and not in the best interests of the shareholders generally.[27] This case is a powerful signal to directors—particularly those who owe their position to a constituency of some kind—that they must not be (or even appear to be) unduly influenced by any particular interest group to the detriment of the company as a whole.[28] Proxy access directors may be particularly vulnerable to claims of influence, lack of independence, and disloyalty because of their relationships with their shareholder sponsors and the web of potentially divergent interests they may be expected to "represent."

Further complicating the position of proxy access directors is the fact that, unlike typical constituency directors, their shareholder sponsors may not be clearly defined or even publicly known. It is understood in the current environment that significant shareholders can and do communicate and collaborate with each other to influence corporate management and policy (a reality that, regrettably, often eludes the reporting requirements under Section 13(d)).[29] Borrowing from so-called "wolf pack" tactics familiar from proxy fights in recent years, shareholder activists could—with or without formal agreements—nominate each other for board seats, increase their positions in target company stock, agree to vote in support of each other's nominees in different companies' elections, and engage in other stratagems to increase and pool

---

[27] New Jersey Carpenters Pension Fund v. infoGROUP, C.A. No. 5334-VCN (Del. Ch. Sept. 30, 2011, revised Oct. 6, 2011).

[28] *See* Steven M. Haas, "Loyalty Claims Against Outside Directors," Feb. 10, 2012, available at blogs.law.harvard.edu/corpgov/2012/02/10/loyalty-claims-against-outside-directors/#more-25500.

[29] *See* Adam O. Emmerich, "Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure, and the Use and Abuse of Shareholder Power," Aug. 27, 2012, available at papers.ssrn.com/sol3/papers.cfm?abstract_id=2138945.

their influence and voting power.[30] A proxy access director nominated pursuant to such tactics would owe his or her position to a group unknown to the board and undisclosed to the other shareholders. If elected, the director's allegiances likewise would be unclear and potentially manifold.

Without an identified constituency, a proxy access director could be subject to influences that may be powerful but poorly understood by the other directors. It could be very difficult for the board to ensure that the proxy access director did not participate in discussions or votes in which the director had a conflict of interest of some kind, though failure to do so could make the board vulnerable to possible breach of fiduciary duty claims and a heightened standard of review of its decisions. It also would be quite difficult for the board to ensure that the company had confidentiality agreements in place with all of the potential recipients of information passed along by the proxy access director, who could face liability if he or she improperly disclosed board deliberations and information to third parties.[31] Moreover, the board may have little incentive to work with the proxy access director, on the theory that if the director did not perform to the expectations of the sponsoring shareholders, he or she may well be replaced the following year by a different nominee. These factors could lead the board to conclude that isolating the director as much as possible from sensitive board deliberations may be the best way to protect the board's decision-making process and the company as a whole from the vulnerability introduced by the proxy access director's presence on the board.

Unintended Consequences

The detrimental consequences of proxy access fall into three general categories. First, there are those that occur before and during the proxy solicitation period. These include waste of corporate resources, negative publicity, the impairment of a company's ability to attract qualified candidates to stand for election as a director, and the undermining of the company's nominating committee and board leadership. Proxy access could cause tension among shareholders, particularly large shareholders, who disagree in public or private over whether to nominate candidates for inclusion in the proxy, and if so, which ones. It also could cause internal controversy for large shareholders; institutional investors or pension funds, for example, may find themselves pressured by certain constituencies (such as unions) to participate in proxy access for political reasons, while other constituencies support the current board's direction on substantive grounds. The instability caused by proxy access—like that created by proxy fights—could create significant disruption in a business, as executives, managers, and employees struggle with fear and uncertainty about the future. Damaging effects on hiring, long-range planning, and employee retention can cause lasting harm to a corporation regardless of the election results.

[30] *See* Anthony Garcia, "Proxy Access Wolf Packs in Sheep's Clothing," FactSet Insight, Jan. 29, 2015, available at www.factset.com/insight/2015/01/proxy-access-wolf-packs-in-sheeps-clothing#.VQ4ucFw-DR0.

[31] For this reason, boards of directors with constituency, blockholder, or proxy access directors should consider adopting a specific board confidentiality policy. Ideally, such a policy would be adopted prior to any such director's election.

Second, there are those consequences that relate to the composition of the board. Were proxy access to become widespread and effective, a board could become unable to ensure that it would have the necessary expertise (such as the audit committee financial expert mandated by the Sarbanes-Oxley Act[32] or industry specialists) or make progress toward a desired diversity of skills, genders, and backgrounds. Moreover, it could create the potential for distrust and a lack of collegiality that would reduce the board's effectiveness and distract the company's management, and it would increase the likelihood of politicization and balkanization of directors into factions with different goals.

Third, there are those consequences that relate to the board's ability to fulfill its legal duties and obligations. Proxy access directors would owe a duty of loyalty to *all* shareholders under Delaware law—as all directors do—yet they might feel themselves to be—or be expected or viewed by others to be—beholden to the particular shareholder group that nominated them and pushed for their election. In conjunction with the paramount issue of loyalty, questions of confidentiality, transparency, board committee structure, and board dynamics could arise. Complications familiar from the constituency/blockholder director context likely would be exacerbated if sponsored directors were to reach the board through proxy access. Boards would be addressing these issues in a context of significant uncertainty, both as to the legal questions of fiduciary duty and as to the factual questions of a proxy access director's allegiance.

If proxy access directors are elected in any meaningful number, boards will be contending with an array of complications that have the potential to impair board functioning in ways that the current debate has not addressed. As the popularity of proxy access reaches a high-water mark this season, shareholders should consider carefully whether they really want what proxy access proponents are asking for. If not, now is the time for them to say so.

[32] Sarbanes-Oxley Act of 2002, Section 401(b).